No. 00-157-CFX Title: United Dominion Industries, Inc., Petitioner
v.
United States

Docketed: July 28, 2000 Court: United States Court of Appeals for the Fourth Circuit

Entry	Date	Proceedings and Orders
	Jul 28 2000	Petition for writ of certiorari filed. (Response due October 27, 2000)
	Aug 24 2000	Order extending time to file response to petition until September 27, 2000.
	Sep 21 2000	Order further extending time to file response to petition until October 27, 2000.
	Oct 24 2000	Brief of respondent United States filed.
	Nov 8 2000	DISTRIBUTED for Conference of November 22, 2000
	Nov 27 2000	Petition GRANTED. SET FOR ARGUMENT March 26, 2001. **********
	Nov 29 2000	Motion of the Solicitor General to dispense with printing the joint appendix filed.
	Dec 8 2000	Motion of respondent for leave to dispense with printing a joint appendix DISTRIBUTED.
	Dec 11 2000	Motion of the Solicitor General to dispense with printing the joint appendix GRANTED.
	Jan 9 2001	Brief amici curiae of National Association of Manufacturers, et al. filed.
	Jan 11 2001	Brief of petitioner United Dominion Industries, Inc. filed.
	Jan 30 2001	CIRCULATED.
	Jan 31 2001	Record filed.
	Feb 12 2001	Brief of respondent United States filed.
	Feb 16 2001	Record filed.
	Mar 14 2001	Reply brief of petitioner United Dominion Industries, Inc. filed.
	Mar 26 2001	ARGUED.

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No. 00-

IN THE

Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether an affiliated group of corporations with a consolidated net operating loss attributable in part to product liability expenses may carry back those expenses for up to ten years as a "product liability loss" under section 172(j)(1) of the Internal Revenue Code of 1954 if the group members that incurred the product liability expenses had positive "separate taxable income" under Treasury Regulation § 1.1502-12.

CORPORATE DISCLOSURE STATEMENT

Petitioner, a publicly held corporation, has no parent, and no publicly held corporation owns 10% or more of its stock.

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United Dominion Industries, Inc., respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case, a judgment which directly conflicts with a substantially contemporaneous judgment by the United States Court of Appeals for the Sixth Circuit.

OPINIONS BELOW

The Fourth Circuit opinion (App. A) is reported at *United Dominion Indus., Inc. v. United States*, 208 F.3d 452 (4th Cir. 2000). The district court opinion (App. B) is reported at *United Dominion Indus., Inc. v. United States*, 98-2 U.S.T.C. (CCH) ¶ 50,527 (Jun. 9, 1998).

STATEMENT OF JURISDICTION

The judgment of the Fourth Circuit Court of Appeals was entered on March 24, 2000. The court of appeals entered an order denying a timely petition for rehearing and suggestion for rehearing en banc on May 19, 2000 (App. C).

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves sections 172(b)(1)(I), 172(c), and 172(j)(1) of the Internal Revenue Code of 1954, and sections 1, 11, 12, 21, 75, and 79 of the consolidated return portion of the Treasury Regulations, § 1.1502, as in effect during the years 1983 through 1986. Because the Treasury Regulations are lengthy, they are set forth separately in *Appendix D*.

For the years in question, section 172(b)(1)(I) provides the following:

> (I) PRODUCT LIABILITY LOSSES. — In the case of a taxpayer which has a product liability loss (as defined in subsection (j)) for a taxable year beginning after September 30, 1979 (referred to in this subparagraph as the "loss year"), the product liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the loss year.

Section 172(j)(1) defines the term "product liability loss" as follows:

> (1) PRODUCT LIABILITY LOSS. — The term "product liability loss" means, for any taxable year, the lesser of —
>
> > (A) the net operating loss for such year reduced by any portion thereof which is attributable to a foreign expropriation loss, or
> >
> > (B) the sum of the amounts allowable as deductions under sections 162 and 165 which are attributable to —
> >
> > > (i) product liability, or
> > >
> > > (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

Section 172(c) defines the term "net operating loss," in pertinent part, as follows:

> (c) NET OPERATING LOSS DEFINED. — For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income.

STATEMENT OF THE CASE

1. When a taxpayer's deductions for a given year exceed its income for that year, the taxpayer for that year has a "net operating loss" for U.S. federal income tax purposes. Section 172 of the Code generally allows a taxpayer to carry back the amount of this net operating loss as an offset to income in any of the three years preceding the loss year. The main reason for this provision is to smooth the taxpayer's income and loss over multiple tax accounting periods.

For the years 1983 through 1986, section 172(b)(1)(I) of the Code allows a taxpayer to carry back the amount of any "product liability loss" for *ten* years, instead of three. The main reason for this extension is that the latent cost of product liability often takes years to emerge, rendering the three-year matching period insufficient. *See* Joint Comm. on Tax'n, 95th Cong., General Explanation of the Revenue Act of 1978, at 232 (Comm. Print 1979). The ten-year carryback has been a part of the federal income tax law since 1979. *See* Revenue Act of 1978, § 371, Pub. L. No. 95-600, 92 Stat. 2763, 2859 (1978).

In 1990, Congress reorganized section 172 and made the term "product liability loss" a subcategory of the term "specified liability loss" in section 172(b)(1)(C) and (f).

See Omnibus Budget Reconciliation Act of 1990, § 11811, Pub. L. No. 101-508, 104 Stat. 1388, 1388-530 (1990). This reorganization did not change the meaning of the term "product liability loss" and simply brought under one subsection all types of expenses entitled to the ten-year carryback. This statute remains in effect to date. *See* I.R.C. § 172(b)(1)(C) & (f) (2000).

Mechanically speaking, a taxpayer's product liability loss or its specified liability loss is the amount of its deductible product liability or specified liability expenses for a given year, limited to the amount of the taxpayer's net operating loss for that year. Thus, for example, if the taxpayer has a net operating loss of $100 and product liability expenses of $80 for a given year, then the taxpayer has a product liability loss of $80. If the taxpayer has no net operating loss for a year, its product liability loss for the year is zero, regardless of whether the taxpayer incurred qualifying expenses in that year. The identical mechanism applies to specified liability losses.

2. This case concerns how the ten-year carryback regime described above applies to affiliated groups of corporations electing to file consolidated federal income tax returns under section 1501 of the Code. Subject to certain exceptions, an affiliated group filing consolidated returns is taxed as if it were a single corporate taxpayer filing a single federal corporate income tax return. The extensive Treasury regulations found under section 1502 and related provisions of the Code generally spell out the tax treatment of such affiliated groups.

Under the consolidated return regulations, an affiliated group calculates its taxable income or net operating loss in a

multi-step process. One early step in this process requires the calculation of each individual group member's "separate taxable income." Under the regulations, a member's separate taxable income is "computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations," subject, however, to several modifications. *See* Treas. Reg. § 1.1502-12 (App. D, at 46a). In broad terms, an affiliated group's consolidated taxable income or net operating loss represents the sum of the positive and negative separate taxable incomes of all group members, subject to numerous, carefully defined modifications. *See generally* Treas. Reg. § 1.1502-11 (computing consolidated taxable income for the group) (App. D, at 44a); Treas. Reg. § 1.1502-21(f) (calculating the consolidated net operating loss) (App. D, at 54a). The consolidated return regulations nowhere discuss the ten-year carryback section 172.

3. The consolidated return regulations draw a distinction between the tax treatment of "consolidated return years" and "separate return years" of affiliated groups. A consolidated return year is any year for which the affiliated group files a consolidated federal income tax return. Treas. Reg. § 1.1502-75(a) (App. D, at 54a-55a). The term "separate return year" means "a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group." Treas. Reg. § 1.1502-1(e) (App. D, at 43a). The consolidated return regulations place restrictions on the ability of an affiliated group to carry back to consolidated return years net operating losses incurred in separate return years, and vice versa. *See* Treas. Reg. § 1.1502-79(a) (App. D, at 55a). Petitioner's claim in this case, however, does not involve

any separate return years, either with respect to the years the expenses at issue were incurred or with respect to the years to which they would be carried.

4. Petitioner is a North Carolina corporation and the parent of an affiliated group of corporations that elected to file consolidated tax returns for tax years 1983 through 1986. For each of those years, Petitioner reported a consolidated net operating loss, as determined under Treas. Reg. § 1.1502-21(f). In each of those years, Petitioner also incurred deductible expenses attributable to product liability, as defined in section 172(j)(1). Petitioner's product liability expenses were incurred by five of Petitioner's twenty-six group members. For the years in question, these five members had positive "separate taxable income," as defined in Treas. Reg. § 1.1502-12.

In 1986 and 1987, Petitioner filed with the Internal Revenue Service (the "IRS") claims for refund with respect to its 1983 through 1986 consolidated tax returns. In its claim, Petitioner asserted that it was entitled, under section 172(b)(1)(I) of the Code, to carry back up to ten years the amount of its product liability expenses incurred in 1983 through 1986. The effect of this carryback would be to reduce Petitioner's taxable income in 1973 through 1976, when Petitioner was profitable, instead of during 1983 through 1986, when Petitioner incurred a consolidated net operating loss. The amount of Petitioner's claim at issue in this case is $1,618,306, plus statutory interest.

5. The IRS agent assigned to review Petitioner's claim for refund allowed the claim with respect to Petitioner's consolidated return years. The agent allowed Petitioner to carry back the product liability expenses incurred during

consolidated return years to offset Petitioner's consolidated taxable income for the years 1973 through 1976. The agent agreed with Petitioner that, for consolidated return years, the term "product liability loss" is determined on a consolidated, group-wide basis.

The Joint Committee on Internal Revenue Taxation, however, reversed the agent's decision and denied Petitioner's claim. The Joint Committee determined that a consolidated group's "product liability loss" must be calculated at the level of each individual group member as if it filed a separate return. Accordingly, the Joint Committee found that Petitioner had no product liability loss because the individual group members that incurred Petitioner's product liability expenses had positive separate taxable income.

6. As a result of the Joint Committee's denial, Petitioner filed a timely suit for refund of federal income taxes in the United States District Court for the Western District of North Carolina. The jurisdiction of the district court was invoked under 28 U.S.C. § 1346(a)(1) and 26 U.S.C. § 7422. In light of the absence of any factual dispute, the parties submitted cross-motions for summary judgment.

In an order dated and filed June 19, 1998 (App. B), the district court granted Petitioner's cross-motion for summary judgment and denied the IRS's cross-motion for summary judgment. The district court held that Petitioner was entitled to the ten-year carryback under section 172(b)(1)(I). The district court reasoned that, with respect to consolidated return years, the amount of the ten-year carryback should be determined on a consolidated basis, not on a separate-company basis, as the IRS contended. (App. B, at 38a–39a).

The district court accordingly entered judgment for Petitioner, awarding a refund in the amount of $1,618,306, plus statutory interest. On September 14, 1998, the IRS filed a notice of appeal.

On March 24, 2000, the Fourth Circuit Court of Appeals reversed the judgment of the district court and remanded the case for further proceedings. The court of appeals rejected the consolidated return approach of the district court. Instead, the court of appeals determined that Petitioner's entitlement to the ten-year carryback for consolidated return years should be determined as if all members of the group had filed separate returns.

The court of appeals, however, also rejected the IRS's methodology for determining the amount of the ten-year carryback. The court applied its own methodology for performing the calculation, based upon Treas. Reg. § 1.1502-79(a). The function of this regulation is to apportion a consolidated net operating loss to separate return years of group members, although no separate return years were involved in this case. The effect of the Fourth Circuit's decision was to eliminate Petitioner's product liability losses. The Fourth Circuit denied Petitioner's petition for rehearing and suggestion for rehearing en banc on May 19, 2000.

REASONS FOR GRANTING THE WRIT

A principal purpose for the Court's certiorari jurisdiction is to resolve conflicts among the United States courts of appeals concerning the meaning of provisions of federal law. *See Braxton v. United States*, 500 U.S. 344, 347 (1991). The Fourth Circuit's decision in this case directly conflicts with the Sixth Circuit's decision in *Intermet Corporation & Subsidiaries v. Commissioner* (App. E), a decision filed less

than one month later. In reviewing a taxpayer's entitlement to the ten-year carryback under a successor provision to section 172(b)(1)(I), the Sixth Circuit explicitly rejected the approach taken by the Fourth Circuit in this case. (App. E, at 75a-74a). This Court regularly has granted certiorari to resolve such disputes. *See, e.g.*, *Nicholas v. United States*, 384 U.S. 678, 681 (1966) (reviewing a conflict between two circuits regarding the interpretation of the federal income tax laws); *United States v. O'Malley*, 383 U.S. 627, 630 (1966) (same); *Bruning v. United States*, 376 U.S. 358, 359 (1964) (same); *Commissioner v. Gillette Motor Trans., Inc.*, 364 U.S. 130, 133 (1960) (same); *Meyer v. United States*, 364 U.S. 410, 411 (1960) (same); *Haynes v. United States*, 353 U.S. 81, 83 (1957) (same); *Millinery Ctr. Bldg. Corp. v. Commissioner*, 350 U.S. 456, 458–59 (1956) (same).

Jurisdiction is particularly appropriate where, as here, the circuit conflict neatly presents an important and recurring question in the administration of the federal income tax laws. *See Donaldson v. United States*, 400 U.S. 517, 522 (1971); *United States v. Correll*, 389 U.S. 299, 301 (1967); *Commissioner v. Duberstein*, 363 U.S. 278, 283 (1960); *Commissioner v. Hansen*, 360 U.S. 446, 450 (1959); *Colony, Inc. v. Commissioner*, 357 U.S. 28, 31–32 (1958). The conflict driven by the Fourth Circuit's opinion will create widespread and continuing uncertainty in corporate business planning and, in addition, will raise the specter of inappropriate judicial rulemaking in a complicated area of tax law, the consolidated return regulations. Accordingly, the Court should grant the petition for a writ of certiorari.

1. Both this case and *Intermet* squarely present the same interpretive problem on substantially identical facts: whether an affiliated group with a consolidated net operating loss may carry back ten years to a consolidated return year the

amount of its product liability or specified liability expenses if the individual group member that incurred those expenses had positive separate taxable income.

In this case, as in *Intermet*, the taxpayer affiliated group incurred deductible expenses that potentially qualified for the ten-year carryback. In both cases, the taxpayer group had a consolidated net operating loss. In both cases, the taxpayer group incurred the expenses at issue in consolidated return years, not in separate return years. In both cases, the taxpayer group sought to carry the qualifying expenses back to consolidated return years, not to separate return years. In both cases, however, the individual group members that incurred the qualifying expenses had positive "separate taxable income" under the consolidated return regulations.

The IRS contended in both cases that the taxpayer was not entitled to the ten-year carryback for the designated expenses because those expenses somehow vanished into the positive separate taxable income of the members that incurred them. The IRS argued that a taxpayer group's entitlement to the ten-year carryback is subject to two independent limitations: the group member incurring the qualifying expenses must have its own "separate company net operating loss" (despite the fact that no such concept exists for consolidated return years), and the consolidated group as a whole must have a consolidated net operating loss. Thus, taking this case as an example, the IRS contended that Petitioner could not have a product liability loss under section 172(b)(1)(I) because the individual members that incurred Petitioner's product liability expenses had positive separate taxable income, and hence none of the expenses could survive to be considered at the consolidated level.

By contrast, Petitioner here and the taxpayer in *Intermet* both argued that a taxpayer's entitlement to the ten-year carryback is determined at the consolidated-group level for consolidated return years. First, the statute itself defines "product liability loss" and "specified liability loss" with reference to "a taxpayer," and the group as a whole is the *only* taxpayer with respect to consolidated return years.

Second, section 172 calculates a taxpayer's product liability loss or specified liability loss by comparing the taxpayer's qualifying expenses with the taxpayer's "net operating loss." The only net operating loss that exists for affiliated groups in consolidated return years is the "consolidated net operating loss," as defined in Treas. Reg. § 1.1502-21(f). While an individual group member may have negative separate taxable income, the consolidated return regulations contain no such concept as a separate company net operating loss for consolidated return years. Hence, the IRS comparison of product liability expenses with separate taxable income is statutorily meaningless.

Third and finally, Petitioner and the taxpayer in *Intermet* argued that the expenses in question were "taken into account," as required by the statute, in computing each taxpayer's consolidated net operating loss. Any increase or decrease in the amount of Petitioner's product liability expenses, for example, would result in an *exactly equivalent* increase or decrease in Petitioner's consolidated net operating loss. In sum, Petitioner and the taxpayer in *Intermet* both argued that a taxpayer's entitlement to the ten-year carryback must be determined at the consolidated-group level for consolidated return years.

Therefore, the statutory and regulatory provisions, the facts, and the arguments of the parties were substantially identical in this case and in *Intermet*.

2. The Fourth Circuit in this case created a new and fundamentally flawed "judicial" consolidated return regulation. In its opinion, the Fourth Circuit endorsed the IRS's misreading of the statute and regulations by limiting Petitioner's product liability loss to the sum of each member's separate-return product liability losses. The Fourth Circuit, however, then departed from the IRS's brief by restricting further each member's product liability loss to the lesser of two items: the member's product liability expenses and the member's "separate return net operating loss" under Treas. Reg. § 1.1502-79(a) (App. A, at 23a).

On its face, the regulation cited by the Fourth Circuit, Treas. Reg. § 1.1502-79(a), simply does not apply. The sole function of that regulation is to determine "[i]f a consolidated net operating loss can be carried . . . *to a separate return year* of a corporation . . . which was a member in the year in which such loss arose." Trans. Reg. § 1.1502-79(a)(1) (emphasis added). As noted above, *no separate return years are at issue in this case* (or in *Intermet*). Accordingly, the Fourth Circuit's application of Trans. Reg. § 1.1502-79(a) only can be construed as a new regulation which imposes separate return concepts and provisions to the determination of consolidated return items. The scope of this new provision is unclear. The Fourth Circuit cited no technical or policy support for its regulation and therefore suggested no limiting rationale. This Court should review the Fourth Circuit's arbitrary and irrational approach to interpreting federal income tax laws.

3. In contrast to the Fourth Circuit's usurpation of regulatory authority from the IRS, the Sixth Circuit's decision in *Intermet* harmonized the plain language of section 172 with the existing consolidated return regulations in a manner that is both equitable and easily administrable.

The Sixth Circuit in *Intermet* sensibly rejected both the reasoning and the result of the Fourth Circuit's decision in this case. The Sixth Circuit held that an affiliated group's entitlement to the ten-year carryback for consolidated return years is determined on a consolidated basis. The court of appeals reasoned that separate taxable income is "simply a step along the way to calculating the group's taxable income or [consolidated net operating loss]" and therefore has "no independent significance" in determining a taxpayer's specified liability loss. (App. E, at 71a). According to the court of appeals, the only "net operating loss" in question is the consolidated net operating loss determined under Treas. Reg. § 1.1502-21(f).

In *Intermet*, the Sixth Circuit considered the Fourth Circuit's approach and expressly rejected it as unpersuasive:

> When reading section 1.1502-79A(a)[1] as a whole, there is no question that it applies only to the separate return scenario. . . . We note that the Fourth Circuit recently held that a consolidated taxpayer is entitled to a "product liability loss" carryback — comparable to the [specified liability loss] carryback—for that portion of an individual

1. Treas. Reg. § 1.1502-79A(a) is the same regulation as Treas. Reg. § 1.1502-79(a). Courts sometimes add the capital letter "A" to regulations in order to designate a regulation promulgated under the Internal Revenue Code of 1954.

> member's product liability expenses that does not exceed the member's "separate net operating loss" as calculated under section 1.1502-79A(a)(3). . . . The court offered no analysis to support its conclusion that Treas. Reg. § 1.1502-79A(a)(3) dictates a method for calculating a member's "separate net operating loss" outside of the separate return context. . . . For the reasons outlined above, we are unpersuaded by the Fourth Circuit's approach.

(App. E, at 73a-74a). The Sixth Circuit therefore held that the taxpayer's entitlement to the ten-year carryback should be determined by comparing the taxpayer's qualifying expenses with its consolidated net operating loss. The Court should resolve the conflict presented in favor of the Sixth Circuit's opinion in *Intermet*.

4. The Court should review the Fourth Circuit's opinion to resolve the uncertainty the opinion creates with respect to corporate restructurings and with respect to the role of the judiciary in the administration of the federal income tax laws.

a. The Fourth Circuit's ruling creates a trap for the unwary. For example, an imperiled corporation that restructures its operations by contributing its various lines of business into separate corporations unwittingly may foreclose its access to the ten-year carryback if the business that incurs qualifying expenses happens to be profitable. The Sixth Circuit's opinion eliminates this trap by preserving single-entity treatment for the group as a whole. As the Sixth Circuit noted, the IRS itself has favored single-entity treatment in the past. (App. E, at 71a-72a). The Court should resolve the conflict between the Fourth and Sixth Circuits to simplify the administration of the federal income tax laws.

b. Just as they do not write laws, courts generally do not write regulations. This prohibition applies with added vigor in the case of the consolidated return regulations, which are legislative in character. *See generally* S. Rep. No. 70-960, at 15 (1928) ("The committee believes it to be impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations. Accordingly, it has found it necessary to delegate power to the commissioner to prescribe regulations legislative in character."). Petitioner's case provides a good example of why courts must not take it upon themselves to write their own regulations. The Fourth Circuit's method of apportioning the consolidated net operating loss to individual group members completely distorts the operation of section 172.

With no supporting rationale, the Fourth Circuit's approach adds Byzantine complexity to an already complex area of the law. Petitioner and the taxpayer in *Intermet* assert that the ten-year carryback amount is the lesser of the group's consolidated net operating loss or the group's product liability expenses. The IRS, by contrast, contends that the ten-year carryback amount is the least of the group's consolidated net operating loss, the sum of each member's product liability expenses, and the sum of each of those particular members' negative separate taxable incomes. The Fourth Circuit, however, would limit the ten-year carryback amount to the least of the group's consolidated net operating loss, the sum of each member's product liability expenses, and the sum of each of those particular members' shares of the group's consolidated net operating loss, apportioned on the basis of the members' relative size. This convoluted calculation, devoid of reason, produces arbitrary and capricious results. Take the following illustration:

A consolidated group consists of a parent corporation and three wholly owned subsidiaries. The parent has no income or loss. Subsidiary A has a loss of $500, of which $100 is attributable to product liability expenses. Subsidiary B has a loss of $10,000. Subsidiary C has income of $10,400. Thus, the taxpayer group has a consolidated net operating loss of $100 ($10,400 - $10,000 - $500).

If Subsidiary A had filed a return as an individual taxpayer, it would have had a product liability loss of $100 (the lesser of the $500 individual loss or the $100 product liability expense), which it could carry back ten years. Under the taxpayer's methodology, the taxpayer affiliated group would have a product liability loss of $100 (the lesser of the $100 group loss or the $100 product liability expense). Even under the IRS approach, misguided as it is, the taxpayer group would have a product liability loss of $100 (the least of the $100 group loss, the $500 negative separate taxable income, or the $100 product liability expense).

Under the Fourth Circuit's approach, however, the group would have a product liability loss of only *$4.76* (the least of the $100 group loss, the $100 product liability expense or, under Reg. § 1.1502-79(a), the $100 group loss, multiplied by Subsidiary A's loss of $500, divided by the sum of all separate losses, $10,500). This unwarranted result occurs solely because the bulk of the group's loss happens to have been incurred by a member with no product liability deductions. No policy rationale exists for determining the ten-year carryback in this arbitrary manner. The Fourth Circuit simply took an unrelated regulation and crammed it in where it did not belong.The Court should bring the Fourth Circuit's decision into conformity with the rational approach offered by the Sixth Circuit's decision in *Intermet*.

5. This case presents the Court with a unique opportunity to resolve the conflict neatly presented by these two cases. The Court is unlikely to find a better case to resolve the conflict at hand. The facts and legal issue in this case and in *Intermet* are virtually identical. The split between the circuits is clear. This case does not burden the Court with extraneous matters, such as the availability of the ten-year carryback for separate return expenses in consolidated return years (or vice versa). To the best of Petitioner's knowledge, no case regarding this issue is currently before a federal court, but Petitioner is aware that this issue has been raised with respect to other taxpayers at the examination stage. The issue presented in these two cases potentially affects all affiliated groups filing consolidated returns. If the issue in this case is left unresolved, then ultimately the IRS, the private sector, and the courts will expend substantial resources developing cases which will not present the issue in question as sharply and cleanly as this case does.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT DATED AND DECIDED MARCH 24, 2000

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 98-2380

UNITED DOMINION INDUSTRIES, INCORPORATED,

Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

Appeal from the United States District Court
for the Western District of North Carolina, at Charlotte.
Graham C. Mullen, Chief District Judge.
(CA-95-341-MU)

Argued: December 2, 1999

Decided: March 24, 2000

Before TRAXLER and KING, Circuit Judges, and
Margaret B. SEYMOUR, United States District Judge
for the District of South Carolina,
sitting by designation.

* * *

Appendix A

OPINION

KING, Circuit Judge:

The question in this case arises from the filing of consolidated tax returns by the predecessor of plaintiff United Dominion Industries, Incorporated (the "taxpayer" or "AMCA"[1]). The taxpayer and the Government (the "IRS") disagree on how to determine the amount of the taxpayer's product liability expenses that may be characterized as "product liability loss."

The IRS appeals from the district court's judgment ordering tax refunds and statutory interest payments to the taxpayer. This dispute involves AMCA's consolidated tax returns for tax years 1983, 1984, 1985, and 1986. On those returns, AMCA characterized the product liability expenses incurred by five of AMCA's twenty-six group members as "product liability loss," which permitted a ten-year carry-back of those losses. The five group members, however, each had positive "separate taxable income," as defined by the consolidated return regulations, in each of the relevant tax return years. The issue on appeal is whether, under these circumstances, these five group members' product liability expenses are properly characterized as "product liability loss" on AMCA's consolidated returns.

The district court entered summary judgment in favor of the taxpayer after the IRS and the taxpayer filed cross-motions for summary judgment. We possess jurisdiction

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1. "AMCA" (AMCA International Corporation) was the predecessor corporation of United Dominion Industries, Incorporated.

pursuant to 28 U.S.C. § 1291. For the reasons explained below, we reverse and remand.

I.

AMCA was the parent of an affiliated group of corporations that properly elected to file consolidated tax returns for tax years 1983 through 1986. In those consolidated tax returns, relying on 26 U.S.C. § 172 (defining "product liability loss" and relevant carryback period, for individual tax returns), AMCA claimed "product liability loss" deductions arising from its group members' product liability expenses.[2] The product liability expenses of five of AMCA's twenty-six group members are at issue in this case. Those members are: Jesco, Inc.; the Cherry-Burrell Corp.; Amtel, Inc.; and Amtel's two subsidiaries, Litwin Corp. and Litwin Panamerican Corp.

The parties agree that the product liability expenses incurred by the five group members in the relevant years total $1,618,306. The parties also agree that during each of the relevant tax years, AMCA's "consolidated net operating loss" was much larger than the product liability expenses that are in dispute. However, with respect to the challenged refunds, the five group members also had positive "separate taxable income" in each of the relevant tax years.[3]

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2. The citations to the Internal Revenue Code and Treasury Regulations in this opinion refer to the respective versions thereof that were in effect between 1983 and 1986.

3. Of note, *see infra* Part III.B.2, the record does not reflect the five group members' "separate net operating loss" for each of

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Appendix A

The taxpayer seeks to apply product liability expenses deductions to AMCA's consolidated tax returns for four years (1983, 1984, 1985, and 1986) for each of these five group members, except in two cases — Amtel in 1983, and Litwin in 1984.[4] The taxpayer sought to characterize all of the five group members' product liability expenses deductions as "product liability loss." Further, the taxpayer seeks to carryback these deductions ten years, pursuant to § 172(b), to AMCA's corresponding consolidated tax returns for tax years 1973 through 1976.[5] The IRS contends that this position

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the relevant years, although Amtel, Litwin, and Litwin Panamerican each appear to have had zero separate net operating loss in 1985. *See Amtel, Inc. v. United States*, 31 Fed. Cl. 598, 601 (1994) (applying Treas. Reg. § 1.1502-79(a)(3) to calculate AMCA's group members' separate net operating loss), *aff'd*, 59 F.3d 181 (Fed. Cir. 1995) (table).

4. The taxpayer concedes that AMCA is not entitled to claim on its 1984 consolidated return a $4,198 product liability loss attributable to one of its group members, Litwin, even though for that year Litwin had a large net operating loss. *See* Brief for Plaintiff-Appellee at 26. The regulations disallow a ten-year carryback of this $4,198 on AMCA's consolidated return, because Litwin was not a member of AMCA's affiliated group in 1974; the loss must therefore be carried back to Litwin's 1974 separate return year. *See* Treas. Regs. §§ 1.1502-21(b)(1) (permitting "consolidated net operating loss" carryovers and carrybacks); 1.1502-79(a) (directing that certain "consolidated net operating loss" carryovers and carrybacks be allocated to separate return years).

5. Cherry-Burrell was formed by AMCA in 1975. The remaining four group members were acquired by AMCA after 1976.
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is erroneous, asserting that because the group members each had positive "separate taxable incomes," their product liability expenses are not "product liability loss." Consequently, according to the IRS, these expenses may not be carried back more than three years.

After the parties agreed there was no genuine issue of material fact, the district court granted summary judgment to the taxpayer on the question of law presented by the cross-motions for summary judgment. In doing so, the court determined that the taxpayer may properly characterize all of its group members' product liability expenses as "product liability loss," because the five group members' aggregated product liability expenses were less than AMCA's consolidated net operating loss. The court accordingly ordered the IRS to refund the taxpayer the sum of $1,618,306 in disputed tax payments, plus statutory interest. We find this decision to be in error, for the reasons explained below.

II.

A.

In the case of a taxpayer who files a separate individual tax return, the tax code establishes a basic framework for

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Whether these members existed or had been acquired by AMCA at that earlier time is not material to our decision today on whether a group member's product liability expenses are properly characterized as "product liability loss," although such facts may be relevant to whether deductions must be carried back to a separate or to a consolidated return year. *See supra* note 4.

determining the amount of product liability expenses that may be characterized as "product liability loss." The difference between the taxpayer's gross income and its allowable deductions reflects either the taxpayer's taxable income, or — if the allowable deductions exceed the gross income — its net operating loss. *See, e.g.*, 26 U.S.C. §§ 63(a) (defining taxable income), 172(c) (defining net operating loss). If a net operating loss results, the taxpayer may characterize its product liability expenses as "product liability loss," to the extent that such expenses do not exceed the taxpayer's net operating loss. *See* 26 U.S.C. § 172(j) (defining "product liability loss" on an individual tax return).[6] Under § 172(j), any "product liability loss" cannot exceed the taxpayer's "net operating loss."

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6. In the context of separate tax returns, § 172 defines the portion of product liability expenses that may be characterized as "product liability loss":

> The term "product liability loss" means, for any taxable year, the lesser of —
>
> (A) the net operating loss for such year . . . , or
>
> (B) the sum of the amounts allowable as deductions under section 162 and 165 which are attributable to —
>
> (i) product liability, or
>
> (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

26 U.S.C. § 172(j)(1).

For example, a taxpayer with a net operating loss of fifty dollars and product liability expenses of seventy-five dollars may characterize no more than fifty dollars of its product liability expenses as "product liability loss." The advantage of such a characterization to the taxpayer is that a deduction for "product liability loss" may be carried backward or forward for up to ten years, rather than the three-year period that is generally available for loss deductions. *See* 26 U.S.C. § 172(b)(1)(A), (I) (defining carryover and carryback time periods).[7] Because on an individual tax return, a taxpayer

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7. For a separate tax return, § 172 also defines the net operating loss carryback provisions:

> (b) Net operating Loss Carrybacks and Carryovers. —
>
> (1) Years to which loss may be carried. —
>
> (A) Except as provided in subparagraphs . . . (I), . . . , a net operating loss for any taxable year shall be a net operating loss carryback to each of the 3 taxable [years preceding] the taxable year of such loss.
>
> . . .
>
> (I) Product liability losses. — In the case of a taxpayer which has a product liability loss (as defined in subsection (j)[)] for a taxable year beginning after September 30, 1979 (referred to in this subparagraph as the "loss year"), the product liability loss shall be a net operating loss carryback to each of the 10 taxable years [preceding] the loss year.

26 U.S.C. § 172(b).

with positive taxable income has no "net operating loss," a corollary is that a taxpayer with positive taxable income must have zero "product liability loss," notwithstanding the amount of its product liability expenses. This is true because the taxpayer must have a net operating loss before any of its product liability expenses may be classified as "product liability loss."

B.

An affiliated group of corporations may properly elect to file a consolidated tax return through the parent corporation, rather than filing individual tax returns for each of the group members. *See* 26 U.S.C. §§ 1501-1505 (authorizing consolidated tax returns). Consolidated tax return calculations have both similarities to, and certain distinctions from, those applicable to individual tax returns.

The consolidated tax return regulations require that some information be calculated separately for each group member, similar to calculations that would be necessary had that member filed its own individual tax return. The "separate taxable income" for a group member is calculated in accordance with the tax code provisions covering the determinations of taxable income of separate corporations, subject to modifications. *See* Treas. Reg. § 1.1502-12 (defining "separate taxable income").[8] One such

8. The "separate taxable income" of a group member excludes deductions that are attributable to certain consolidated amounts, as specified in Treas. Reg. § 1.1502-12 subsections:

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modification, for example, is that no net operating loss deduction may be taken into account when computing a group member's "separate taxable income." *See id.*

Thus, pursuant to the consolidated returns regulations, some important and relevant tax return information from the group members is not included in these per-group-member calculations. Instead, that tax return information is separately designated and utilized in consolidated form. These consolidated amounts and the per-group-member amounts are then combined into the parent corporation's "consolidated taxable income," which accumulates all the relevant information by taking into account: (i) the "separate taxable income of each member of the group;" and (ii) deductions attributable to seven different consolidated amounts, *e.g.*, any "consolidated net operating loss" deduction, and any

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(h) (net operating loss);

(j) (capital gains or losses);

(k) (gains or losses subject to section 1231);

(l) (section 170 charitable contributions);

(m) (section 922 (relating to the deduction for Western Hemisphere trade corporations)); and

(n) (dividends received and dividends paid, pursuant to sections 243(a)(1), 244(a), 245, or 247).

See Treas. Reg. § 1.1502-12.

consolidated charitable contributions deduction. *See* Treas. Reg. § 1.1502-11(a) (generally defining "consolidated taxable income").[9]

C.

The question in this case — how to properly determine the amount of product liability expenses that may be

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9. The "consolidated taxable income" for a consolidated tax return is determined pursuant to Treas. Reg. § 1.1502-11(a), by taking into account:

(1) each group member's "separate taxable income;"

(2) any consolidated net operating loss deduction;

(3) any consolidated capital gain net income . . . ;

(4) any consolidated section 1231 net loss;

(5) any consolidated charitable contributions deduction;

(6) any consolidated section 922 deduction;

(7) any consolidated dividends received deduction;

(8) any consolidated section 247 deduction.

See Treas. Reg. § 1.1502-11(a). The above deductions, taken into account in calculating the parent's "consolidated taxable income" pursuant to Treas. Reg. § 1.1502-11(a), mirror those deductions excluded from the calculation of a group member's "separate taxable income" pursuant to Treas. Reg. § 1.1502-12. *See supra* note 8.

characterized as "product liability loss" on a consolidated tax return — arises because, before such expenses may be characterized as "product liability loss," a preliminary determination must be made that a net operating loss has occurred. *Cf.* 26 U.S.C. § 172(j) (defining "product liability loss" on an individual tax return); *see* discussion *supra* Part II.A. Both the tax code and the regulations are silent as to whether this "product liability loss" characterization should be determined on a per-group-member basis or on a consolidated basis. The regulations, however, lay the groundwork for this determination by defining several relevant terms: the group members' "separate taxable income" (*see* Treas. Reg. § 1.1502-12) and "separate net operating loss" (*see* Treas. Reg. § 1.1502-79(a)); and the parent corporation's "consolidated taxable income" (*see* Treas. Reg. § 1.1502-11) and "consolidated net operating loss" (*see* Treas. Reg. § 1.1502-21(f)).

On a consolidated tax return, each group member has its associated "separate taxable income." A group member's "separate taxable income" is not analogous to a corporation's taxable income on an individual tax return, however, because unlike the individual's taxable income, the "separate taxable income" does not reflect the full extent of that group member's profitability or loss. This is so because, on consolidated tax returns, some deductible amounts attributable to the group member are instead reflected elsewhere, in consolidated form. *See supra* note 8 (*e.g.*, net operating loss not taken into account in group member's "separate taxable income").

The consolidated deductions that are not reflected in the group member's "separate taxable income" but are fairly

attributable to the group member, are, however, reflected in the "separate net operating loss" of the group member. The "separate net operating loss" of a group member is determined from the "separate taxable income," with adjustments for certain items, including items taken into account in the computation of the consolidated net operating loss. *See* Treas. Reg. § 1.1502-79(a)(3) (formula for apportioning "consolidated net operating loss" to a member, when carryback must go to the member's separate return year).[10] As a result of the incorporation of the consolidated

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10. The "separate net operating loss" of a group member as defined in Treas. Reg. § 1.1502-79(a)(3) (formula for apportioning "consolidated net operating loss" to a member for allocation to a separate tax return year), is determined from its "separate taxable income" under Treas. Reg. § 1.1502-12 (except that no deduction is allowed under section 242), adjusted for the group member's portion of the following items taken into account in the computation of the consolidated net operating loss:

> (i) consolidated dividends received deduction, consolidated charitable contributions deduction, and consolidated section 247 deduction;
>
> (iv) consolidated net capital loss carryover which is absorbed in the taxable year;

and adjusted for the following items taken into account in the consolidated net operating loss computation:

> (ii) the member's capital gain net income;
>
> (iii) the member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such member.

See Treas. Reg. § 1.1502-79(a)(3).

deduction adjustments in the group members' "separate net operating loss" but not in their "separate taxable income," it is possible that a group member may have positive "separate taxable income" at the same time it has a positive "separate net operating loss."[11]

The consolidated tax return regulations also define the parent corporation's "consolidated taxable income," which takes into account the group members' "separate taxable incomes" and deductions attributable to seven consolidated items. *See supra* note 9. Further, the regulations also define the parent's "consolidated net operating loss," which, like its "consolidated taxable income," combines the group members' "separate taxable incomes" with enumerated consolidated deductions. *See* Treas. Reg. § 1.1502-21(f) (defining "consolidated net operating loss").[12]

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11. This is importantly different from the case of an individual tax return, where if either the individual's taxable income or net operating loss is positive, the other value must be zero.

12. The "consolidated net operating loss" is determined pursuant to Treas. Reg. § 1.1502-21(f) by taking into account:

(1) the group members' "separate taxable income";

(2) any consolidated capital gain net income . . . ;

(3) any consolidated section 1231 net loss;

(4) any consolidated charitable contributions deduction;

(5) any consolidated dividends received deduction; and

(6) any consolidated section 247 deduction.

See Treas. Reg. § 1.1502-21(f).

Appendix A

Having reviewed the pertinent terminology and provisions of the code and regulations, we now turn to the facts of this case to determine how the per-group-member and consolidated items apply to the question before us.

III.

Our standard of review is clear: we review de novo the grant or denial of a motion for summary judgment. *Henson v. Liggett Group, Inc.*, 61 F.3d 270, 274 (4th Cir. 1995).

A.

The taxpayer has adopted a single-entity approach in calculating its "product liability loss" for AMCA's 1983 through 1986 consolidated tax returns. The methodology is the same for each of the challenged tax years' calculations. The taxpayer's single-entity approach does not require a group member incurring deductible product liability expenses to have also incurred a net operating loss. According to the taxpayer, only AMCA's aggregated product liability expenses and net operating loss amounts are relevant to the characterization of these expenses as "product liability loss."

Specifically, the taxpayer applied the single-entity method as follows. First, for each tax year, the taxpayer aggregated all twenty-six AMCA group members' product liability expenses. *See* 26 U.S.C. § 172(j) (defining "product liability loss" on an individual tax return). The taxpayer then calculated AMCA's "consolidated net operating loss" for that tax year. *See* Treas. Reg. § 1.1502-21(f) (defining "consolidated net operating loss"). Because AMCA's

aggregated product liability expenses were less than AMCA's "consolidated net operating loss" for that tax year, and since in the case of a separate tax return, under § 172(j)(1), a corporation's product liability expenses that are less than or equal to its "net operating loss" are characterized as "product liability loss," the taxpayer characterized AMCA's aggregated product liability expenses as "product liability loss." This characterization permits the taxpayer to deduct the entirety of these expenses from income earned up to ten years prior, and to receive tax credits thereon. Under the taxpayer's view, for example, a group member with fifty dollars of product liability expenses could contribute all fifty dollars toward the "product liability loss" on the parent corporation's consolidated tax return, so long as the consolidated net operating loss was greater than the aggregate of all the group members' product liability expenses.

The IRS disagrees with the taxpayer's single-entity method for defining "product liability loss" on consolidated tax returns, and therefore rejects the taxpayer's characterization of its aggregated product liability expenses as "product liability loss." The IRS emphasizes that there are fundamental differences between relevant portions of the consolidated returns regulations and the separate returns regulations, and that the consolidated regulations take precedence here.

Put simply, we agree with the IRS that the taxpayer's single-entity method is improper. The principal advantage in filing a consolidated return is income blending: the losses of unprofitable group members can offset the income of

profitable group members and mitigate the current tax liability. *Amtel, Inc. v. United States*, 31 Fed. Cl. 598, 600 (1994), *aff'd*, 59 F.3d 181 (Fed. Cir. 1995) (table). The regulations provide for blending the group members' net operating losses, and they explicitly define a "consolidated net operating loss" without an accompanying reference to consolidated product liability expenses. This omission is important here and makes clear that blending those expenses is not permitted, *i.e.*, that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated "product liability loss" is not intended. *Cf.* 26 U.S.C. § 172(c), (j) (defining "net operating loss" and "product liability loss" on an individual tax return). This omission also confirms that product liability expenses are linked to the consolidated net operating loss only through their nexus to the group member, so that any related tax carryback benefits are therefore also tied to the group member.[13]

The IRS further contends that under the taxpayer's single-entity method of characterizing the group member's product liability expenses, the parent corporation obtains a

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13. The enumerated modifications taken into account when computing a group member's "separate taxable income" do not refer to product liability losses. The calculation of a group member's "separate taxable income" therefore includes the member's product liability expense deduction. *See, e.g.*, 26 U.S.C. §§ 162 (permitting trade or business expense deductions), 165 (permitting deductions for loss), 172(j)(1) (defining "product liability loss"). Further, product liability loss is not referred to in the "consolidated net operating loss" definition.

windfall tax benefit. We agree that, were the taxpayer's reasoning to prevail, the parent corporation could obtain the extended ten-year carryback for losses incurred by individual group members (that are reflected in the parent's "consolidated net operating loss"), although the losses were not the result of product liability expenses (and thus could not be "product liability loss"). This occurs by the parent corporation's characterization of all of a group member's product liability expenses as "product liability loss," even though some of these expenses came from group members that incurred no "separate net operating loss." Because the tax regulations plainly provide the ten-year carryback only for "product liability loss" (and not for product liability expenses), we conclude that an interpretation removing the close nexus between such expenses and whether the affected company operated at a loss is inconsistent with the regulations.

B.

Having rejected the taxpayer's single-entity method for determining "product liability loss" on a consolidated return, we now turn to establishing the proper method for doing so. We conclude that determining "product liability loss" separately for each group member is correct and consistent with the regulations. The regulations suggest two possible methods, however, for determining "product liability loss" from a group member's product liability expenses. Under these possible methods of calculation, a member's "product liability loss" may be either: (a) the amount of product liability expenses that do not exceed the group member's negative "separate taxable income," or (b) the amount of

product liability expenses that do not exceed the group member's "separate net operating loss."

1.

The IRS proposes that the group member's negative "separate taxable income," calculated pursuant to Treas. Reg. § 1.1502-12, should establish the threshold for determining the group's "product liability loss" amount. To the contrary, we agree with the taxpayer that the IRS's proposed method for determining "product liability loss" on consolidated returns is incorrect.

The IRS contends that whether a portion of a group member's product liability expenses can be characterized as "product liability loss" turns on whether the group member had a negative "separate taxable income." The IRS thus proposes that the "net operating loss" on a separate return is most analogous to a group member's "separate taxable income" on a consolidated return. In the IRS's view, a group member with positive "separate taxable income" has no losses under the consolidated return regulations, and therefore has no "product liability loss," despite having product liability expenses. For example, the IRS urges that a group member with fifty dollars of product liability expenses and negative ten dollars "separate taxable income" could contribute no more than ten dollars toward the "product liability loss" on the parent corporation's consolidated tax return.

The taxpayer points out that the group member's "separate taxable income" is not analogous to a net operating

loss on a separate return, because "separate taxable income" by definition excludes income and deductions that would be incorporated in calculating the group member's taxable income or net operating loss, if the group member had filed a separate tax return. *See* Treas. Reg. § 1.1502-12 (defining "separate taxable income"). Therefore, the taxpayer says, the "separate taxable income" cannot be an appropriate reference for determining whether the group member incurred a loss from product liability expenses. We agree. *See* discussion *supra* Part II.C.

On a separate tax return, the net operating loss is the amount by which the allowable deductions exceed the taxpayer's gross income. *See* 26 U.S.C. § 172(c) (defining net operating loss). Allowable deductions include deductions attributable to, *e.g.*, charitable contributions and net operating loss.[14] *See, e.g.*, 26 U.S.C. §§ 170 (charitable contributions), 172(a) (net operating loss). Thus, the net operating loss as defined on a separate return reflects that, in a broad sense, the taxpayer had more expenditures than income. On a consolidated return, the "separate taxable income" does not reflect an analogous difference between a group member's income and expenses, because expenses that are fairly attributable to the group member are excluded from the "separate taxable income." For example, a member's charitable contributions and attributable net operating loss deductions are excluded from its "separate taxable income," and instead are included elsewhere, in consolidated form only. *See, e.g.*, Treas. Reg. §§ 1.1502-12 ("separate taxable

14. A net operating loss deduction may be available, for example, by the taxpayer's carryback or carryforward from another tax year.

income"), 1.1502-11(a) (listing consolidated items). Thus, a group member may have a positive "separate taxable income" notwithstanding that the member had a charitable contribution of, say, two or three times the amount of its "separate taxable income." According to the view of the IRS, the member's positive "separate taxable income" would bar any of that member's product liability expenses from being characterized as "product liability loss."

We are constrained to reject the position taken by the IRS. The result in our above example is flatly contrary to the separate tax return analogy from § 172(j) — there, if an individual's charitable contribution exceeds its gross income, a net operating loss results. This net operating loss would therefore permit the individual taxpayer's product liability expenses to be characterized as "product liability loss."[15] Further, the IRS presents no affirmative reason to justify using a group member's "separate taxable income" to limit the member's contribution to "product liability loss," and we conclude there is none. A group member can, and often will, have a net operating loss (in the sense of § 172, after accounting for all the amounts attributable to that member), despite the member's positive "separate taxable income." *See supra* note 11. In such a case, the group member's product liability expenses may qualify as "product liability loss." Having rejected the IRS's proposed reference to the member's "separate taxable income" in the determination of whether the member's product liability expenses are "product liability loss," we must go further, and consider

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15. The "product liability loss" amount would be limited, of course, by the amount of the net operating loss. *See* 26 U.S.C. § 172(j).

how to properly determine "product liability loss" on a consolidated return.

The taxpayer argues that "product liability loss" is determined by reference to net operating loss. We agree with this assertion. However, the taxpayer goes further, and claims that for a consolidated return, the net operating loss only exists on a consolidated basis. *See* 26 U.S.C. § 172(j)(1) (defining "product liability loss" on an individual tax return); Treas. Reg. § 1.1502-21(f) (defining "consolidated net operating loss"). Therefore, the taxpayer asserts, product liability expenses must also be consolidated in order to compare those expenses to the consolidated net operating loss, so as to calculate the "product liability loss." On this point, we disagree with the taxpayer.

2.

The regulations governing consolidated returns provide a simple and direct method for determining the portion of a group member's product liability expenses that are "product liability loss." The regulations define a group member's "separate net operating loss," *see* Treas. Reg. § 1.1502-79(a)(3), which is analogous to an individual's "net operating loss" on a separate return. By comparing each member's product liability expenses to its "separate net operating loss," that member's "product liability loss" may be properly calculated. The parent's "product liability loss" is then calculated as the total of the members' "product liability loss."

First, the regulations define the portion of the consolidated net operating loss that is attributable to a group

member.[16] *See* Treas. Reg. § 1.1502-79(a) (apportionment of consolidated net operating loss to a group member, for purposes of carrying back to a separate return year).[17] Application of this apportionment formula to the issue in this case results in logical consistency of the general consolidated return framework, and the specific resolution of the issue in this case.

A group member's "separate net operating loss" incorporates the portion of the consolidated net operating loss allocated to that member (calculated pursuant to Treas. Reg. § 1.1502-79(a)(3)), and is analogous to a § 172(c) net operating loss. That is, the member's "separate net operating loss" takes into account, for example, that member's charitable contributions and net operating loss deductions — and in this sense, it is unlike the member's "separate

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16. A group member's portion of the consolidated net operating loss is:

> the consolidated net operating loss multiplied by a fraction, the numerator of which is the separate net operating loss of such corporation, and the denominator of which is the sum of the separate net operating losses of all members of the group in such year having such losses.

Treas. Reg. § 1.1502-79(a)(3). The regulation further provides the method for determining the "separate net operating loss" of a group member. *Id. See also supra* note 10.

17. The amount of net operating loss apportioned to a group member does not and should not depend upon whether any resulting carryback will be applied to a separate or a consolidated return year.

taxable income."[18] Therefore, a group member's product liability expenses that are not in excess of that group member's "separate net operating loss" is that member's "product liability loss," analogous to § 172(j). The sum of the group members' "product liability loss" provides the parent corporation's total "product liability loss."[19] For example, a group member with fifty dollars of product liability expenses, negative ten dollars "separate taxable income," and fifteen dollars "separate net operating loss" could contribute a maximum of fifteen dollars toward the "product liability loss" on the parent corporation's consolidated tax return.

The tax carryback benefits available to the parent corporation from the group member's product liability expenses are thus properly limited by the group member's portion of the consolidated net operating loss, analogous to the limit that would be imposed if the group member had filed a separate tax return. Our resolution today maintains the required nexus between a group member's net operating loss and its product liability expenses, as implied by the consolidated return regulations, in the definition of the "product liability loss" deduction on a consolidated return.

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18. A group member's "separate net operating loss" is more analogous than its "separate taxable income" to the § 172 "net operating loss" on an individual tax return. *See* discussion *supra* Part III.B.1.

19. If a group member's portion of the consolidated net operating loss must be carried back to the group member's separate return year, pursuant to Treas. Reg. § 1.1502-79, then the "product liability loss" for that group member must likewise be carried back to the group member's separate return year. *Cf. supra* note 4.

IV.

In conclusion, we reject the taxpayer's single-entity approach to the determination of "product liability loss" on a consolidated return. Instead, we conclude that each group member's "product liability loss" must be appropriately determined, and that the parent's "product liability loss" is calculated as the aggregate of the group members' "product liability loss." As to the proper method to determine each group member's "product liability loss," we reject the position of the IRS that a group member's "product liability loss" is its product liability expenses to the extent that those expenses are not in excess of the group member's negative "separate taxable income."

We therefore hold that, on a consolidated return, a group member's product liability expenses that do not exceed that member's "separate net operating loss," calculated pursuant to Treas. Reg. § 1.1502-79(a)(3), may be characterized as "product liability loss." We further hold that the parent's "product liability loss" is properly determined as the aggregate of its group members' "product liability loss."

Pursuant to the foregoing, we reverse the judgment of the district court and remand this case for further proceedings consistent with this decision.

REVERSED AND REMANDED

APPENDIX B — ORDER OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NORTH CAROLINA, CHARLOTTE DIVISION DATED AND FILED JUNE 19, 1998

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION
3:95-CV-341-MU

UNITED DOMINION INDUSTRIES, INC.,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

ORDER

This matter involves a tax dispute between United Dominion Industries, Inc., ("UDI") and the Internal Revenue Service ("IRS" or "Service"). UDI contends that the United States has erroneously denied UDI the right to carry back to the years 1973, 1974, 1975 and 1976 consolidated product liability losses arising in 1983, 1984, 1985 and 1986 in the amounts of $205,919; $1,609,340, $1,333,788 and $250,550,[1] respectively. UDI seeks judgment in the amount

1. UDI asserts that the IRS erroneously denied UDI the right to carry back $250,550 in losses arising in 1986. However, the sum of the product liability losses of the five members at issue for 1986 is $232,402.

of the corresponding refund. These figures represent the deductions attributable to product liability as defined in section 172(j) of the Internal Revenue Code of 1954 ("the Code") of five members of AMCA's consolidated group for the years in which those five members posted positive separate taxable income.[2]

The parties have filed cross motions for summary judgment pursuant to Fed. R. Civ. P. 56. The parties agree that there are no genuine issues of material fact, and each believes that it is entitled to judgment as a matter of law.

I. FACTS

This tax dispute relates to the consolidated tax returns of UDI's corporate predecessor, AMCA International Corporation ("AMCA"). For each of the years between 1983 and 1986, AMCA was a member of a consolidated group that reported consolidated net operating losses of between $85 and $140 million. During that time, AMCA's consolidated return group included, among others, the following five corporations: Jesco, Inc. ("Jesco"), Cherry-Burrell Corporation ("Cherry-Burrell"); Amtel, Inc. ("Amtel"); The Litwin Corporation ("Litwin"); and Litwin Panamerican Corporation ("Panamerican").

AMCA acquired Jesco in 1978 and sold it to an unrelated purchaser in 1995. Between 1983 and 1986, Jesco reported positive separate taxable income. During those same years,

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2. All citations to the Internal Revenue Code and Treasury Regulations in this opinion shall refer to the versions of the Code and Regulations that were in effect between 1983 and 1986.

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Litwin recorded deductions attributable to product liability totalling $166,042 for 1993; $1,402,931 for 1994; $1,292,733 for 1995; and $127,682 for 1996.

AMCA formed Cherry-Burrell in September 1975 and liquidated it in 1991. Between 1983 and 1986, Cherry-Burrell reported positive separate taxable income. During those years. Cherry-Burrell also reported deductions attributable to product liability. Those losses totalled $34,608 in 1983; $192,287 in 1984; $8,642 in 1985; and $87,760 in 1986.

AMCA acquired Amtel in 1977. Amtel reported positive separate taxable income for 1984, 1985 and 1986, but not for 1983. Amtel recorded deductible product liability losses of $12,135 in 1984; $13,218 in 1985; and $7,549 in 1986.

Litwin was an Amtel subsidiary that joined the consolidated group when AMCA acquired Amtel in 1977. Litwin reported positive separate taxable income for 1983, 1985 and 1986, but not for 1984. Litwin's deductions attributable to product liability during that period were $5,250 in 1983; $4,198 in 1984; $14,139 in 1985; and $8,909 in 1986.

Panamerican was also an Amtel subsidiary that joined the consolidated group when AMCA acquired Amtel in 1977. Panamerican reported positive separate taxable income between 1983 and 1986. The company incurred deductible losses attributable to product liability of $19 in 1983; $1,987 in 1984; $5,056 in 1985; and $502 in 1986.

During 1986 and 1987, AMCA sought refunds based on Internal Revenue Code ("I.R.C." or "Code") § 172(b)(1)(I)

and Treas. Reg. § 1.1502-79(a)(3), claiming the 1983, 1984, 1985 and 1986 product liability losses of Jesco, Amtel, Litwin and Panamerican as ten-year carrybacks to the respective separate return years of each of these four companies. The Revenue Agent assigned to review those claims for refund determined that the losses in question could not be carried back to the separate return years of Jesco, Amtel, Litwin and Panamerican because, with the exception of Litwin in 1984, these companies each had positive separate taxable income for the years in which they incurred product liability losses.

The agent, however, treated AMCA's claims for refund as also claiming that the 1983, 1984, 1985 and 1986 product liability losses of Jesco, Amtel, Litwin and Panamerican were properly treated as part of AMCA's consolidated product liability losses for each of those years which could be carried back against AMCA's consolidated taxable income. Although the agent proposed to allow the carry backs to AMCA's consolidated return, the Joint Committee on Internal Revenue Taxation reviewed and reversed the agent's decision. AMCA also filed refund claims based on product liability losses that Cherry-Burrell incurred between 1983 and 1986; the agent proposed to allow those losses but was again reversed by the Joint Committee on Internal Revenue Taxation.

UDI thereafter brought this action, seeking a refund based on the product liability losses that it asserts it should have been permitted to carry back to its consolidated returns for 1973, 1974, 1975 and 1976.

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II. PARTIES' CONTENTIONS

A. Plaintiff's Motion for Summary Judgment

UDI contends that "[t]he only substantive issue in this case is the extent to which . . . the AMCA . . . consolidated group is entitled, under section 172(b)(1)(I) of the Internal Revenue Code of 1954 . . . to include in the 10 year carrybacks of its product liability losses incurred in the years 1983, 1984, 1985 and 1986 the deductions attributable to product liability of certain members of its group." Plaintiff's Brief at 1.

With respect to the product liability loss of a consolidated group, Plaintiff maintains that "[t]he only appropriate inquiry is whether the consolidated group has both a net operating loss and deductions attributable to product liability." Plaintiff's Brief at 9. That is, the appropriate assessment is not whether individual entities within the group post deductions attributable to product liability, but whether the consolidated group as a whole has done so. Thus, Plaintiff asserts that even if individual members of the consolidated group generated positive separate taxable income during the loss years at issue, the consolidated group may tally those companies' deductions attributable to product liability for the purpose of a ten-year carryback on the consolidated return.

According to UDI, the mechanics of the consolidated return regulations dictate that the product liability losses of a consolidated group be determined on a single entity basis. Under Reg. § 1.1502-12, each member of a consolidated

group computes its own separate taxable income. However, this computation does not take into account elements such as net operating loss carryovers, which Reg. § 1.1502-11 requires that taxpayers compute on a consolidated basis. The sole definition of a consolidated group's net operating loss appears at Reg. § 1.1502-21(f). That figure is determined by taking into account each entity's separate taxable income, with remaining items calculated on a consolidated basis only, wholly apart from separate taxable income. UDI thus concludes that a corporation that is a member of a consolidated group is incapable of having its own net operating loss under the consolidated return regulations. Because of this, UDI maintains that "simple logic compels the conclusion that the only manner in which section 172(j)(1) can be applied to a consolidated group is to compare its consolidated net operating loss with deductions attributable to product liability also calculated on a group wide basis." Plaintiff's Brief at 19. UDI also maintains that the single entity approach is required to apply all provisions of I.R.C. § 172 consistently.

B. Defendant's Motion for Summary Judgment

The United States contends that the interplay between section 172 and sections 1501 and 1502 dictate that summary judgment be entered in its favor. The United States maintains that product liability losses under section 172(j) must be computed separately for each member of a consolidated group. It further maintains that applying section 172(j) on a consolidated basis would conflict with the opinion in *Amtel, Inc. v. United States*, 31 Fed. Cl. 598 (1994), Treas Reg. § 1.1502-11, Treas. Reg. § 1.1502-79(a), and the language of section 172 itself.

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The United States maintains that the *Amtel* court specifically rejected Amtel's creation of a 'consolidated product liability loss deduction' because of the phrase's absence from the code and its regulations. 31 Fed. Cl. at 602. The United States declares that in this case, Plaintiff has merely changed the destination of the carry back at issue in *Amtel*, and that the theory and method rejected in *Amtel* are the same as those currently at issue.

According to the United States, allowing computation of the product liability loss deduction on a consolidated basis would conflict with Treas. Reg. § 1.1502-11 because it does not contain the concept of a "consolidated product liability loss deduction." The United States also notes that nothing in the consolidated return regulations provides for the computation of product liability deductions on a consolidated basis. Accordingly, the United States contends, a product liability loss as defined in section 172(j) can become part of a consolidated net operating loss only as a portion of the separate net operating losses of its members.

The United States contends that Treas. Reg. § 1.1502-79 is implicated in this case because some of the affiliated members of UDI's group of corporations that filed a consolidated return had separate return years for years to which the plaintiff's consolidated net operating loss could potentially be carried back. It declares that if Section 172(j) is applied on a consolidated basis, Treas. Reg. § 1.1502-79(a)(3) becomes unworkable. This is because an apportionment of a consolidated product liability loss results in member corporations with separate taxable income being apportioned part of the loss. However, the United States says,

only members with separate net operating losses are to be apportioned part of the loss.

The United States further argues that because deductions attributable to product liability do not exist on a consolidated level but do exist in the computation of separate taxable income or loss of a group's members, Section 172(j) must be applied only on the level of each separate member corporation.

III. ANALYSIS.

A. Jurisdiction

This Court has jurisdiction to hear tax refund suits under 28 U.S.C. § 1346(a)(1). However, the Internal Revenue Code provides a number of steps that a taxpayer must undertake within certain prescribed time periods before this Court may exercise jurisdiction under 28 U.S.C. § 1346(a)(1).

Under section 7422(a), Plaintiff must first have filed a claim for a refund before maintaining a refund suit. The statute of limitations for filing a claim for refund is three years from the time the return was filed or two years from payment of the tax. I.R.C. § 6511(a). An exception to the statute of limitations exists when a taxpayer agrees to an extension of the statute of limitations relating to the period during which a tax audit must be completed. I.R.C. § 6511(c)(1). Under the exception, "[t]he period for filing claim for credit or refund . . . shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof under section 6501(c)(4)." *Id.*

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If a "claim or credit or refund relates to an overpayment attributable to a net operating loss carryback . . . the period [of limitations] shall be that period which ends 3 years after the time prescribed by law for filing the return (including extensions thereof) for the taxable year of the net operating loss . . . which results in such carryback, or the period prescribed in subsection (c) [relating to the exception to the general limitation period], whichever expires later . . . ." I.R.C. § 6511(d)(2)(A).

UDI entered into an agreement with the Internal Revenue Service ("IRS") to extend until June 30, 1994 the statute of limitations on assessment of tax by the IRS for the years December 31, 1982 through December 31, 1988. During 1986 and 1987, AMCA filed various claims for refund based on the product liability losses of the five member companies at issue in this litigation. All of these refund claims were filed within the statutorily allowable period.

Taxpayers may not bring refund suits "before the expiration of 6 months from the date of filing the claim of refund . . . nor after the expiration of 2 years from the date of mailing by certified mail or registered mail by the Secretary to the taxpayer of a notice of the disallowance." I.R.C. § 6532(a)(1). If a taxpayer files a written waiver of the requirement that the taxpayer be mailed a notice of disallowance, the 2 year limitation in section 6532(a)(1) begins on the date the waiver is filed. I.R.C. § 6532(a)(3). UDI met the first requirement of section 6532(a)(1) because it filed suit more than six months after it filed the required claims for refund. UDI also met the second requirement because it neither received statutory notice of a disallowance nor waived the right to receive such notice.

For the foregoing reasons, all jurisdictional requirements of the Code have been met and this Court has jurisdiction under 28 U.S.C. § 1346(a).

B. Summary Judgment Standard

Rule 56 of the Federal Rules of Civil Procedure directs that summary judgment be entered when a moving party shows "that there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law." *Ross v. Communications Satellite Corp.*, 759 F.2d 355, 364 (4th Cir. 1985). The parties in this case agree that there are no factual disputes. Thus, the party entitled to judgment as a matter of law shall prevail on its motion for summary judgment.

C. Statutory Framework

The Internal Revenue Code provisions that, together with their regulations, address this case are 26 U.S.C. §§ 1501, 1502 and 172.

Section 1501 is among the provisions of the Code that exists for affiliated groups of corporations. Section 1501 allows affiliated groups that meet certain conditions to file consolidated returns. Neither party disputes that the AMCA group properly filed consolidated returns for the years at issue in this case.

Section 1502 authorizes the Secretary of the Treasury to promulgate regulations for groups of corporations filing consolidated returns. Under Reg. § 1.1502-2, the tax liability

of a consolidated group for a consolidated return year is determined by adding together a number of components, the first of which is "the tax imposed by section 11 [of the Code] on the consolidated taxable income for such year."

Consolidated taxable income for a consolidated return year is determined under Treas. Reg. § 1.1502-11 by taking into account eight separate items. The first of these is "[t]he separate taxable income of each member of the group." Reg. § 1.1502-11. Separate taxable income, which is computed pursuant to Reg. § 1.1502-12, "is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to several modifications. Treas. Reg. § 1.1502-12. One of those modifications states that "[n]o net operating loss deduction shall be taken into account." Treas. Reg. § 1.1502-12(h). A net operating loss deduction is the sum of the net operating loss carryovers and carrybacks to a given tax year. I.R.C. § 172(a). The parties agree that for the years in dispute, the group members at issue (with the exception of Amtel in 1983 and Litwin in 1984) posted positive separate taxable income pursuant to these calculations.

Net operating losses are the subject of section 172. Under section 172, taxpayers may generally carry back net operating losses for three years preceding the taxable year in which they incurred the losses. The section contains an exception for product liability losses sustained in taxable years beginning after September 20, 1979. That exception provides that "[i]n the case of a taxpayer which has a product liability loss . . . , the product liability loss shall be a net operating loss carry back to each of the 10 taxable years preceding the

loss year." I.R.C. § 172(b)(1)(I) This exception applies to the product liability losses for each of the loss years in dispute in this case.

The Code defines "product liability loss" as the lesser of a net operating loss or "the sum of the amounts allowable as deductions under sections 162 and 165 which are attributable to (i) product liability, or (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability." I.R.C. § 172(j)(1). Under this definition, a company's product liability loss is merely a subset of its net operating loss. Thus, it is the portion of a company's net operating loss that is attributable to product liability that companies may carry back for the extended ten-year period.

If the composition of a consolidated group remained constant over a decade, the consolidated group's net operating losses (including the portion that constitutes its product liability loss) could be carried back on a consolidated basis to offset the group's aggregate taxable income. Further, no apportionment need occur if there is involved "a prior separate return year for which such member was not in existence and shall be included in the consolidated net operating loss carrybacks to the equivalent consolidated return year of the group . . . provided that such member was a member of the group immediately after its organization." Treas. Reg. 1.1502-79(a)(2). Because Cherry-Burrell was part of the consolidated group immediately after its incorporation in 1975, its product liability losses for 1985 and 1986 should be considered wholly on a consolidated basis. Thus, its product liability loss should be compared to

the AMCA group's net operating loss. Because Cherry-Burrell's product liability losses are smaller than the group's net operating losses, UDI is entitled to a refund representing the ten-year carrybacks from Cherry-Burrell's 1985 and 1986 product liability losses.[3]

Most of the members of the consolidated group in the case at bar did not remain constant over the relevant decade. The deductions at the center of this dispute arose between 1983 and 1986. Because section 172 allows ten-year carrybacks for product liability losses, the losses could be carried back to years between 1973 and 1976. In 1973 and 1974, none of the five member companies that generated the product liability losses were members of AMCA's consolidated group. In 1975 and 1976, all of the companies at issue in this litigation except Cherry-Burrell filed separate returns.

"[A] taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group" constitutes a separate return year. Treas. Reg. § 1.1502-1(e). When separate return years are at issue, apportionment rules must be used to

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3. The holding in *Amorient, Inc. v. Commissioner*, 103 T.C. 161 (1994), does not preclude this result. *Amorient* holds that a consolidated group cannot carry back to a consolidated return of the same consolidated group any part of a net operating loss that Treas. Reg. § 1.1502-79(a)(1) requires be carried back to a separate return year. In this case, the no net operating losses or product liability losses are allowed to be carried back to separate return years. Therefore, no losses are deducted from the those that may be carried back to consolidated returns.

determine the portion of the consolidated net operating losses that should not involved in computation of the consolidated group's taxable income. Specifically, the apportionment regulation is invoked when "a consolidated net operating loss can be carried under the principles of section 172(b) . . . to the separate return years of a corporation." Treas. Reg. § 1.1502-79(a)(1)(i). This case involves product liability losses. Because the Code permits a company to carry back these losses ten years, they can be carried to separate return years of the five group members that are central to this litigation. Thus, the facts of this case fall among situations to which Treas. Reg. § 1.1502-79 applies. That regulation requires that if a loss can be apportioned, then it shall be considered a net operating loss carryover or carryforward to the separate return year. *Id.* Any loss that is considered a carryover to a separate return year is thereafter not eligible to "be included in the consolidated net operating loss carryovers . . . to the equivalent consolidated return year." *Id.*

When consolidated net operating losses are apportioned, then so too must be the subset that constitutes product liability losses. The definition of a product liability loss must then be applied to the apportioned amounts. The lesser of a company's net operating loss or its deductions attributable to product liability — a product liability loss as defined under section 172(j)(1) — is zero for the years in which a company had positive separate taxable income. Therefore, none of the net operating loss may be carried back for 10 years as a product liability loss to the separate return years of each of the companies that posted taxable income. Similarly, none of the net operating loss is eligible to be included in the

carryovers to the equivalent consolidated return year. Because none of the product liability loss is excluded from use on the consolidated group's return, the product liability loss may be compared to the remainder of the group's net operating losses. If the group's net operating losses total more than the product liability losses not apportioned to separate returns — which, in this case, would be all of the deductions attributable to product liability sustained in the loss years at issue — then the entire product liability loss may be carried back the full ten years to the group's consolidated return. This result is unsurprising. As Plaintiff notes in its brief: "This is a simple, plain vanilla case, involving only a single consolidated group and its effort to carry a net operating loss from one consolidated return year to another consolidated return year of the same group."

D. Collateral Estoppel

The United States asserts that allowing consideration of section 172 on a consolidated basis would conflict with the decision rendered in *Amtel v. United States*, 31 Fed. Cl. 598 (1994). *Amtel* involved product liability deductions of the same consolidated taxpayer at issue in this case. *Amtel* arose because the taxpayer sought to carry back to a separate return year a product liability loss from a consolidated return year. At issue in that case was tax year 1985, for which the corporation had a consolidated net operating loss of $85.5 million, with $6.1 million in deductions attributable to product liability. Although group member Amtel generated positive separate taxable income, the company sought to carry back the product liability losses 10 years to a separate return year.

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The *Amtel* court disallowed any refund for a carry back of a product liability deduction for Amtel because of the separate return year, which changed the nature of the treatment of the consolidated group's net operating loss. As the *Amtel* court said, "[t]he term 'net operating loss' in the context of a consolidated income tax return generally means the net operating loss of the consolidated group as a whole, and not the separate net operating loss of a member." *Amtel*, 31 Fed. Cl. at 600. However, "[t]he IRS does not apply the single entity approach when a taxpayer seeks to carry back a net operating loss from a consolidated return year to a separate return year. In that context, the Service treats members as separate by apportioning the consolidated net operating loss." *Id.*

Because Amtel's net operating loss had to be apportioned, its product liability loss under Section 172(j)(1) was limited to its own 1985 net operating loss, which was zero. In so holding, the court rejected Amtel's argument that only the group's consolidated net operating loss and aggregate product liability deductions should be compared. The court stated that the "regulations do not use the term 'product liability loss' or incorporate such a concept by directing that product liability loss be treated on a consolidated basis." 31 Fed. Cl. at 602.

Amtel neither governs nor collaterally estops prosecution of this case. In *Amtel*, the question was whether losses might be carried back to a separate return year. The court in that case rejected the notion of a "consolidated" product liability loss only to the extent that such a loss was an attempt to supersede the individual tax attributes of a member company for a separate return year.

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IT IS THEREFORE ORDERED that

(1) the United States shall allow UDI to carry back ten years to its consolidated returns the product liability losses at issue in this case;

(2) UDI and the United States shall recompute and reconfirm the total deductions allowed and the amount of the refund due UDI and within 30 days shall report that amount to the Court so that the Court may issue a final judgment in this case; and

(3) upon entry of a final judgment, the United States shall refund to UDI the total deductions computed in accordance with this Order.

This 19th day of June, 1998.

s/ Graham C. Mullen
THE UNITED STATES
DISTRICT JUDGE
GRAHAM C. MULLEN

APPENDIX C — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT DENYING PETITION FOR REHEARING DATED AND FILED MAY 19, 2000

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 98-2380
CA-95-341-MU

UNITED DOMINION INDUSTRIES,
INCORPORATED

Plaintiff – Appellee

v.

UNITED STATES OF AMERICA

Defendant – Appellant

On Petition for Rehearing and Rehearing En Banc

The appellee's petition for rehearing and rehearing en banc was submitted to this Court. As no member of this Court or the panel requested a poll on the petition for reheating en banc, and

As the panel considered the petition for rehearing and is of the opinion that it should be denied,

IT IS ORDERED that the petition for rehearing and rehearing en banc is denied.

For the Court,

/s/ Patricia S. Connor
CLERK

APPENDIX D — REGULATIONS INVOLVED

26 C.F.R. § 1.1502-1 (1986)

§ 1.1502-1. **Definitions.** — (a) *Group.* The term "group" means an affiliated group of corporations as defined in section 1504. See § 1.1502-75(d) as to when a group remains in existence.

(b) *Member.* The term "member" means a corporation (including the common parent) which is included within such group.

(c) *Subsidiary.* The term "subsidiary" means a corporation other than the common parent which is a member of such group.

(d) *Consolidated return year.* The term "consolidated return year" means a taxable year for which a consolidated return is filed or required to be filed by such group.

(e) *Separate return year.* The term "separate return year" means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group.

(f) *Separate return limitation year* — (1) *In general.* Except as provided in subparagraphs (2) and (3) of this paragraph, the term "separate return limitation year" means any separate return year of a member or of a predecessor of such member. The term "predecessor" means a transferor or distributor of assets to a member in a transaction to which section 381(a) applies.

(2) *Exceptions.* The term "separate return limitation year" shall not include —

(i) A separate return year of the corporation which is the common parent for the consolidated return year to which the tax attribute is to be carried (except as provided in § 1.1502-75(d)(2)(ii) and subparagraph (3) of this paragraph),

(ii) A separate return year of any corporation which was a member of the group for each day of such year, or

(iii) A separate return year of a predecessor of any member if such predecessor was a member of the group for each day of such year,

provided that an election under section 1562(a) (relating to the privilege to elect multiple surtax exemptions) was never effective (or is no longer effective as a result of a termination of such election) for such year. An election under section 1562(a) which is effective for a taxable year beginning in 1963 and ending in 1964 shall be disregarded.

* * *

26 C.F.R. § 1.1502-11 (1986)

§ 1.1502-11. **Consolidated taxable income.** — (a) *In general.* The consolidated taxable income for a consolidated return year shall be determined by taking into account —

(1) The separate taxable income of each member of the group (see § 1.1502-12 for the computation of separate taxable income);

(2) Any consolidated net operating loss deduction (see § 1.1502-21 for the computation of the consolidated net operating loss deduction);

(3) Any consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (see § 1.1502-22 for the computation of the consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977));

(4) Any consolidated section 1231 net loss (see § 1.1502-23 for the computation of the consolidated section 1231 net loss);

(5) Any consolidated charitable contributions deduction (see § 1.1502-24 for the computation of the consolidated charitable contributions deduction);

(6) Any consolidated section 922 deduction (see § 1.1502-25 for the computation of the consolidated section 922 deduction);

(7) Any consolidated dividends received deduction (see § 1.1502-26 for the computation of the consolidated dividends received deduction); and

(8) Any consolidated section 247 deduction (see § 1.1502-27 for the computation of the consolidated section 247 deduction).

* * *

Appendix D

26 C.F.R. § 1.1502-12 (1986)

§ 1.1502-12. **Separate taxable income.** — The separate taxable income of a member (including a case in which deductions exceed gross income) is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to the following modifications:

(a) Transactions between members and transactions with respect to stock, bonds, or other obligations of members shall be reflected according to the provisions of §§ 1.1502-13 and 1.1502-14;

(b) Any deduction which is disallowed under § 1.1502-15 shall be taken into account as provided in that section;

(c) The limitation on deductions provided in section 615(c) or section 617(h) shall be taken into account as provided in § 1.1502-16;

(d) The method of accounting under which such computation is made and the adjustments to be made because of any change in method of accounting shall be determined under § 1.1502-17;

(e) Inventory adjustments shall be made as provided in § 1.1502-18;

(f) Any amount included in income under § 1.1502-19 shall be taken into account;

(g) In the computation of the deduction under section 167, property shall not lose its character as new property as a result of a transfer from one member to another member during a consolidated return year if —

(1) The transfer occurs on or before January 4, 1973, or

(2) The transfer occurs after January 4, 1973, and the transfer is a deferred intercompany transaction as defined in § 1.1502-13(a)(2) or the basis of the property in the hands of the transferee is determined (in whole or in part) by reference to its basis in the hands of the transferor;

(h) No net operating loss deduction shall be taken into account;

(i) [Reserved]

(j) No capital gains or losses shall be taken into account;

(k) No gains and losses subject to section 1231 shall be taken into account;

(l) No deduction under section 170 with respect to charitable contributions shall be taken into account;

(m) No deduction under section 922 (relating to the deduction for Western Hemisphere trade corporations) shall be taken into account;

(n) No deductions under section 243(a)(1), 244(a), 245, or 247 (relating to deductions with respect to dividends received and dividends paid) shall be taken into account;

(o) Basis shall be determined under §§ 1.1502-31 and 1.1502-32, and earnings and profits shall be determined under § 1.1502-33; and

(p) The limitation on deductions provided in section 613A shall be taken into account for each member's oil and gas properties as provided in § 1.1502-44.

(q) A thrift institution's deduction under section 593(b)(2) (relating to the addition to the reserve for bad debts of a thrift institution under the percentage of taxable income method) shall be determined under § 1.1502-42.

The term "separate taxable income" shall include a case in which the determination under this section results in an excess of deductions over gross income.

26 C.F.R. § 1.1502-21 (1986)

§ 1.1502-21. **Consolidated net operating loss deduction.** — (a) *In general.* The consolidated net operating loss deduction shall be an amount equal to the aggregate of the consolidated net operating loss carryovers and carrybacks to the taxable year (as determined under paragraph (b) of this section).

(b) *Consolidated net operating loss carryovers and carrybacks* — (1) *In general.* The consolidated net operating loss carryovers and carrybacks to the taxable year shall consist of any consolidated net operating losses (as determined under paragraph (f) of this section) of the group, plus any net operating losses sustained by members of the

group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b). However, such consolidated carryovers and carrybacks shall not include any consolidated net operating loss apportioned to a corporation for a separate return year pursuant to paragraph (a) of § 1.1502-79, and shall be subject to the limitations contained in paragraphs (c), (d), and (e) of this section and to the limitation contained in § 1.1502-15.

* * *

(3) *Absorption rules.* For purposes of determining the amount, if any, of a net operating loss (whether consolidated or separate) which can be carried to a taxable year (consolidated or separate), the amount of such net operating loss which is absorbed in a prior consolidated return year under section 172(b)(2) shall be determined by —

(i) Applying all net operating losses which can be carried to such prior year in the order of the taxable years in which such losses were sustained, beginning with the taxable year which ends earliest, and

(ii) Applying all such losses which can be carried to such prior year from taxable years ending on the same date on a pro rata basis, except that any portion of a net operating loss attributable to a foreign expropriation loss to which section 172(b)(1)(D) applies shall be applied last.

(c) *Limitation on net operating loss carryovers and carrybacks from separate return limitation years* — (1) *General rule.* In the case of a net operating loss of a

member of the group arising in a separate return limitation year (as defined in paragraph (f) of § 1.1502-1) of such member (and in a separate return limitation year of any predecessor of such member), the amount which may be included under paragraph (b) of this section (computed without regard to the limitation contained in paragraph (d) of this section) in the consolidated net operating loss carryovers and carrybacks to a consolidated return year of the group shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph with respect to a member of the group is the excess, if any, of —

(i) Consolidated taxable income (computed without regard to the consolidated net operating loss deduction), minus such consolidated taxable income recomputed by excluding the items of income and deduction of such member, over

(ii) The net operating losses attributable to such member which may be carried to the consolidated return year arising in taxable years ending prior to the particular separate return limitation year.

(3) *Examples.* The provisions of this paragraph and paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). (i) Corporation P formed corporations S and T on January 1, 1965. P, S, and T filed separate returns

for the calendar year 1965, a year for which an election under section 1562 was effective. T's return for that year reflected a net operating loss of $10,000. The group filed a consolidated return for 1966 reflecting consolidated taxable income of $30,000 (computed without regard to the consolidated net operating loss deduction). Among the transactions occurring during 1966 were the following:

(*a*) P sold goods to T deriving deferred profits of $7,000 on such sales, $2,000 of which was restored to consolidated taxable income on the sale of such goods to outsiders:

(*b*) T sold a machine to S deriving a deferred profit of $5,000, $1,000 of which was restored to consolidated taxable income as a result of S's depreciation deductions;

(*c*) T distributed a $3,000 dividend to P; and

(*d*) In addition to the transactions described above, T had other taxable income of $6,000.

(ii) The carryover of T's 1965 net operating loss to 1966 is subject to the limitation contained in this paragraph, since 1965 was a separate return limitation year (an election under section 1562 was effective for such year). Thus, only $7,000 of T's $10,000 net operating loss is a consolidated net operating loss carryover to 1966, since such carryover is limited to consolidated taxable income (computed without regard to the consolidated net operating loss deduction), $30,000, minus such consolidated taxable income recomputed by excluding the items of income and deduction of T, $23,000 (*i.e.*, consolidated taxable income computed

without regard to the $1,000 restoration of T's deferred gain and T's $6,000 of other income). In making such recomputation, no change is made in the effect on consolidated taxable income of P's sale to T,, or of the dividend from T to P.

Example (2). (i) Corporation P was formed on January 1, 1966. P filed separate returns for the calendar years 1966 and 1967 reflecting net operating losses of $4,000 and $12,000, respectively. P purchased corporation S on March 15, 1967. S was formed on February 1, 1966, and filed a separate return for the taxable year ending January 31, 1967. S also filed a short period return for the period from February 1 to December 31, 1967, and joined with P in filing a consolidated return for 1968. S sustained net operating losses of $5,000 and $6,000 for its taxable years ending January 31, 1967 and December 31, 1967, respectively. An election under section 1562 was not effective for P and S during the period involved. Consolidated taxable income for 1968 (computed without regard to the consolidated net operating loss deduction) was $16,000; such consolidated taxable income recomputed by disregarding the items of income and deduction of S was $9,000.

(ii) In order of time, the following losses are absorbed in 1968:

(*a*) P's $4,000 net operating loss for the calendar year 1966 (such loss is not subject to the limitation contained in this paragraph since P is the common parent corporation for 1968);

(*b*) S's $5,000 net operating loss for the year ended January 31, 1967. Such loss is subject to the limitation contained in this paragraph, since S was not a member of the group on each day of such year. However, such loss can be carried over and absorbed in full since such limitation is $7,000 (consolidated taxable income computed without regard to the consolidated net operating loss deduction, $16,000, minus such consolidated taxable income recomputed, $9,000); and

(*c*) $6,000 of P's net operating loss and $1,000 of S's net operating loss for the taxable years ending December 31, 1967. This is determined by applying the losses from such year which can be carried to 1968 (P's $12,000 loss and $2,000 of S's $6,000 loss, since such $6,000 loss is limited under this paragraph) on a pro rata basis against the amount of such losses which can be absorbed in that year, $7,000 (consolidated taxable income of $16,000 less the $9,000 of losses absorbed from prior years). The carryover of S's loss to 1968 is subject to the limitation contained in that paragraph, since S was not a member of the group on each day of its taxable year ending December 31, 1967. Such loss is limited to $2,000, the excess of $7,000 (as determined under (ii)(*b*)) over $5,000 (S's carryover from the year ended January 31, 1967). If a consolidated return is filed in 1969, the consolidated net operating loss carryovers will consist of P's unabsorbed loss of $6,000 ($12,000 minus $6,000) from 1967 and, subject to the limitation contained in this paragraph, S's unabsorbed loss of $5,000 ($6,000 minus $1,000) from its year ended December 31, 1967.

* * *

(f) *Consolidated net operating loss.* The consolidated net operating loss shall be determined by taking into account the following:

(1) The separate taxable income (as determined under § 1.1502-12) of each member of the group, computed without regard to any deduction under section 242;

(2) Any consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977);

(3) Any consolidated section 1231 net loss;

(4) Any consolidated charitable contributions deduction;

(5) Any consolidated dividends received deduction (determined under § 1.1502-26 without regard to paragraph (a)(2) of that section); and

(6) Any consolidated section 247 deduction (determined under § 1.1502-27 without regard to paragraph (a)(1)(ii) of that section).

26 C.F.R. § 1.1502-75 (1986)

§ 1.1502-75. **Filing of consolidated returns.** — (a) *Privilege of filing consolidated returns* — (1) *Exercise of privilege for first consolidated return year.* A group which did not file a consolidated return for the immediately preceding taxable year may file a consolidated return in lieu of separate returns for the taxable year, provided that each

corporation which has been a member during any part of the taxable year for which the consolidated return is to be filed consents (in the manner provided in paragraph (b) of this section) to the regulations under section 1502. If a group wishes to exercise its privilege of filing a consolidated return, such consolidated return must be filed not later than the last day prescribed by law (including extensions of time) for the filing of the common parent's return. Such consolidated return may not be withdrawn after such last day (but the group may change the basis of its return at any time prior to such last day).

(2) *Continued filing requirement.* A group which filed (or was required to file) a consolidated return for the immediately preceding taxable year is required to file a consolidated return for the taxable year unless it has an election to discontinue filing consolidated returns under paragraph (c) of this section.

* * *

26 C.F.R. § 1.1502-79 (1986)

§ 1.1502-79. **Separate return years.** — (a) *Carryover and carryback of consolidated net operating losses to separate return years.* — (1) *In general.* If a consolidated net operating loss can be carried under the principles of section 172(b) and paragraph (b) of § 1.1502-21 to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member in the year in which such loss arose, then the portion of such consolidated net operating loss attributable to such

corporation (as determined under subparagraph (3) of this paragraph) shall be apportioned to such corporation (and any successor to such corporation in a transaction to which section 381(a) applies) and shall be a net operating loss carryover or carryback to such separate return year; accordingly, such portion shall not be included in the consolidated net operating loss carryovers or carrybacks to the equivalent consolidated return year. Thus, for example, if a member filed a separate return for the third year preceding a consolidated return year in which a consolidated net operating loss was sustained and if any portion of such loss is apportioned to such member for such separate return year, such portion may not be carried back by the group to its third year preceding such consolidated return year.

(ii) If a corporation ceases to be a member during a consolidated return year, any consolidated net operating loss carryover from a prior taxable year must first be carried to such consolidated return year, notwithstanding that all or a portion of the consolidated net operating loss giving rise to the carryover is attributable to the corporation which ceases to be a member. To the extent not absorbed in such consolidated return year, the portion of the consolidated net operating loss attributable to the corporation ceasing to be a member shall then be carried to such corporation's first separate return year.

(2) *Nonapportionment to certain members not in existence.* Notwithstanding subparagraph (1) of this paragraph, the portion of a consolidated net operating loss attributable to a member shall not be apportioned to a prior separate return year for which such member was not in

existence and shall be included in the consolidated net operating loss carrybacks to the equivalent consolidated return year of the group (or, if such equivalent year is a separate return year, then to such separate return year), provided that such member was a member of the group immediately after its organization.

(3) *Portion of consolidated net operating loss attributable to a member.* The portion of a consolidated net operating loss attributable to a member of a group is an amount equal to the consolidated net operating loss multiplied by a fraction, the numerator of which is the separate net operating loss of such corporation, and the denominator of which is the sum of the separate net operating losses of all members of the group in such year having such losses. For purposes of this subparagraph, the separate net operating loss of a member of the group shall be determined under § 1.1502-12 (except that no deduction shall be allowed under section 242), adjusted for the following items taken into account in the computation of the consolidated net operating loss:

(i) The portion of the consolidated dividends received deduction, the consolidated charitable contributions deductions, and the consolidated section 247 deduction, attributable to such member;

(ii) Such member's capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (determined without regard to any net capital loss carryover attributable to such member);

(iii) Such member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such member (as determined under paragraph (b)(2) of this section); and

(iv) The portion of any consolidated net capital loss carryover attributable to such member which is absorbed in the taxable year.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) Corporation P was formed on January 1, 1966. P filed a separate return for the calendar year 1966. On March 15, 1967, P formed corporation S. P and S filed a consolidated return for 1967. On January 1, 1968, P purchased all the stock of corporation T, which had been formed in 1967 and had filed a separate return for its taxable year ending December 31, 1967.

(ii) P, S, and T join in the filing of a consolidated return for 1968, which return reflects a consolidated net operating loss of $11,000. $2,000 of such consolidated net operating loss is attributable to P, $3,000 to S, and $6,000 to T. Such apportionment of the consolidated net operating loss was made on the basis of the separate net operating losses of each member as determined under subparagraph (3) of this paragraph.

(iii) $5,000 of the 1968 consolidated net operating loss can be carried back to P's separate return for 1966. Such amount is the portion of the consolidated net operating loss

attributable to P and S. Even though S was not in existence in 1966, the portion attributable to S can be carried back to P's separate return year, since S (unlike T) was a member of the group immediately after its organization. The 1968 consolidated net operating loss can be carried back against the group's income in 1967 except to the extent (*i.e.*, $6,000) that it is apportioned to T for its 1967 separate return year and to the extent that it was absorbed in P's 1966 separate return year. The portion of the 1968 consolidated net operating loss attributable to T ($6,000) is a net operating loss carryback to its 1967 separate return.

Example (2). (i) Assume the same facts as in example (1). Assume further that on June 15, 1969, P sells all the stock of T to an outsider, that P and S file a consolidated return for 1969 (which includes the income of T for the period January 1 through June 15), and that T files a separate return for the period June 16 through December 31, 1969.

(ii) The 1968 consolidated net operating loss, to the extent not absorbed in prior years, must first be carried to the consolidated return year 1969. Any portion of the $6,000 amount attributable to T which is not absorbed in T's 1967 separate return year or in the 1969 consolidated return year shall then be carried to T's separate return year ending December 31, 1969.

* * * *

APPENDIX E — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT IN *INTERMET CORPORATION & SUBSIDIARIES v. COMMISSIONER OF INTERNAL REVENUE* DATED, DECIDED AND FILED APRIL 20, 2000

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 99-1046

INTERMET CORPORATION & SUBSIDIARIES,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

On Appeal from the United States Tax Court.
No. 8246-97 — Thomas B. Wells, Tax Court Judge.

Argued: December 6, 1999

Decided and Filed: April 20, 2000

Before: RYAN and SUHRHEINRICH, Circuit Judges; BELL, District Judge.*

* * *

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* The Honorable Robert Holmes Bell, United States District Judge for the Western District of Michigan, sitting by designation.

Appendix E

OPINION

RYAN, Circuit Judge. This case requires us to decide whether an affiliated group of corporations filing a consolidated federal income tax return is entitled to a 10-year carryback for certain "specified liability" expenses incurred by a member corporation with positive separate taxable income. We conclude that the 10-year carryback is applicable under this scenario. Therefore, we will REVERSE the judgment of the United States Tax Court and REMAND to that court for further proceedings consistent with this opinion.

I.

The relevant facts are undisputed. Intermet Corporation is the common parent of an affiliated group of corporations that manufactures precision iron castings for automotive and industrial equipment producers. The group filed consolidated federal income tax returns for calendar years 1984 through 1992. The group's members used the accrual method of accounting for both financial accounting and federal income tax purposes during this time period.

Intermet claimed that in 1992 it incurred certain "specified liability" (SL) expenses attributable to several member corporations. At issue in this appeal are certain claimed SL expenses incurred by Lynchburg Foundry Co., a member of the group between 1984 and 1992. Lynchburg's claimed SL expenses in 1992 consisted of: (1) $717,617 (plus $299,412.63 in interest) to cover its Michigan Single Business Tax liability for 1986, 1987, and 1988; and (2) interest on its 1987 federal income tax liability in the amount of $2,175.60.

Appendix E

In 1992, Lynchburg had a positive "separate taxable income" (STI), as defined under the Treasury Regulations, of $3,940,085. The STI was positive because Lynchburg's gross income exceeded its deductions. Lynchburg deducted its claimed SL expenses in calculating its 1992 STI. On the other hand, Intermet had a $25,701,038 "consolidated net operating loss" (CNOL) under the Treasury Regulations in 1992, far exceeding Lynchburg's claimed SL expenses.

In 1994, Intermet filed an amended income tax return to carry back to 1984 the claimed SL expenses incurred by Lynchburg during 1992. Intermet claimed this carryback on the ground that the expenses qualified for the 10-year carryback provision for "specified liability loss" (SLL) deductions under the Internal Revenue Code. On March 14, 1997, the IRS issued a notice of deficiency for calendar year 1984, disallowing the carryback. Intermet filed a petition in the United States Tax Court contesting the deficiency determination.

The case was submitted to the Tax Court on a fully stipulated record, presenting the following issues: (1) whether the claimed SL expenses fit the statutory definition of a SLL under I.R.C. § 172(f)(1)(B) (1994) (amended in 1998); and (2) whether Intermet could take advantage of the SLL 10-year carryback where the group had a CNOL but the member that incurred the SL expenses had a positive STI. The Tax Court held in favor of the IRS on issue two, and did not reach the first issue. *Intermet Corp. & Subsidiaries v. Commissioner*, 111 T.C. 294 (1998).

The Tax Court reasoned that Lynchburg's SL expenses did not qualify for the SLL carryback because they were not

"taken into account" in computing Intermet's net operating loss (NOL) for 1992, as required by the Internal Revenue Code. *Id.* at 304-05. The court first noted that Lynchburg had no separate or individual NOL in 1992 because its gross income exceeded allowable deductions. *Id.* at 300. The Tax Court then proceeded to determine whether Lynchburg's SL expenses were "taken into account" in computing Intermet's CNOL. Relying on the Treasury Regulations, the court concluded that they were not. *Id.* at 301-03.

The court correctly noted that the consolidated return regulations do not treat members' SL expenses on a consolidated basis for purposes of calculating a group's CNOL. Instead, SL expenses are netted against a member's income in computing a member's STI, which is then used to calculate the group's CNOL. Based upon these regulations, the Tax Court reasoned an SL expense is "absorbed" by a group member's current income in computing the member's positive STI, and the "exhausted" expenses cannot be used by the group or parent for purposes of the 10-year SLL carryback. *Id.* at 302.

Intermet timely appealed the Tax Court's judgment, maintaining that it satisfied the statutory requirements for the SLL carryback. Specifically, Intermet contends that Lynchburg's SL expenses were "taken into account" in calculating Intermet's CNOL because the expenses were used in calculating Lynchburg's STI which, in turn, was used to calculate Intermet's CNOL. It makes no difference, Intermet agrees, whether Lynchburg's STI was positive or negative because Lynchburg's SL expenses would have a direct, dollar-for-dollar impact on both Lynchburg's STI and Intermet's CNOL in either event.

II.

Since the facts are undisputed and this case presents a pure question of law, we review the Tax Court's judgment *de novo*. *Estate of Mueller v. Commissioner*, 153 F.3d 302, 304 (6th Cir. 1998), *cert. denied*, 525 U.S. 1140 (1999). Statutory "provisions granting a [tax] deduction . . . are matters of legislative 'grace' and are construed strictly (in favor of the government)." *Weingarden v. Commissioner*, 825 F.2d 1027, 1029 (6th Cir. 1987). The taxpayer bears the burden of pointing to a clear provision entitling it to a claimed deduction. *Indopco, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

Where an agency regulation interprets an ambiguous statutory provision, we limit our review to whether the regulation is a reasonable, but not necessarily the best, interpretation. *Atlantic Mut. Ins. Co. v. Commissioner*, 523 U.S. 382, __, 118 S. Ct. 1413, 1418 (1998). An agency's interpretation of its own ambiguous regulation also deserves substantial deference if the interpretation is reasonable insofar as it " 'sensibly conforms to the purpose and wording of the regulations.' " *Martin v. Occupational Safety and Health Review Comm'n*, 499 U.S. 144, 151 (1991) (quoting *Northern Indiana Pub. Serv. Co. v. Porter Cty. Chapter of Izaak Walton League of Am., Inc.*, 423 U.S. 12, 15 (1975)). *See also Martin v. American Cyanamid Co.*, 5 F.3d 140, 144 (6th Cir. 1993).

III.

This case presents a straightforward issue, but one that arises in the context of a complex regulatory framework.

We therefore proceed to summarize that framework as it existed in 1992, the relevant year here.

The Internal Revenue Code permits a taxpayer to carry an NOL forward to future taxable years or back to preceding taxable years to offset taxable income generated in those years, yielding a tax refund. I.R.C. § 172(b) (1994). This provision " 'permit[s] a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year.' " *Six Seam Co. v. United States*, 524 F.2d 347, 351 (6th Cir. 1975) (quoting *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957)). In 1992, the general carryback period was three years preceding the year in which the NOL was incurred. I.R.C. § 172(b)(1)(A)(i) (1994) (amended in 1997). In 1997, the three-year carryback was reduced to two years.

The Code extends the carryback period to 10 years for certain "specified liability losses." *Id.* § 172(b)(1)(C) (1994). A transition rule enacted in 1990 prohibits the SLL carryback to years preceding 1984. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11811(b)(2)(B), 104 Stat. 1388 (1990).

As of 1992, the Code defined SLL as follows:

> **(1) In general.** — The term "specified liability loss" means the sum of the following amounts to the extent taken into account in computing the net operating loss for the taxable year:
>
> . . .

> **(B)** Any amount . . . allowable as a deduction under this chapter with respect to a liability which arises under a Federal or State law . . . if —
>
> > **(i)** In the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year . . . .
>
> A liability shall not be taken into account under subparagraph (B) unless the taxpayer used an accrual method of accounting throughout the period or periods during which the acts or failures to act giving rise to such liability occurred.
>
> **(2) Limitation.** — The amount of the specified liability loss for any taxable year shall not exceed the amount of the net operating loss for such taxable year.

I.R.C. § 172(f) (1994) (amended in 1998). Thus, a taxpayer is entitled to the SLL carryback if, among other things: (1) SL expenses as defined under section 172(f)(1)(B) exist; (2) the taxpayer has an NOL for the year; (3) the SL expenses are "taken into account" in calculating the NOL; and (4) the SLL carryback does not exceed the NOL for the year.

The Code permits an affiliated group of corporations to file a consolidated return in lieu of separate income tax

returns. It does not address whether, or how, the SLL carryback provision applies in the consolidated return context. Rather, the Code delegates to the Secretary of the Treasury broad authority to prescribe regulations

> as he may deem necessary in order that the tax liability of any affiliated group of corporations . . . may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

Id. § 1502. To file a consolidated return, all member organizations must agree to comply with the consolidated return regulations. *Id.* § 1501. Among the advantages of consolidated returns are the ability to offset gains and losses of group members and "greater utilization of NOL . . . carryovers." *Wolter Constr. Co. v. Commissioner*, 634 F.2d 1029, 1031 n.1 (6th Cir. 1980).

The Treasury Regulations comprise "the bulk of the 'law' " addressing consolidated returns. *Id.* at 1032. Unfortunately, the regulations do not specifically address the application of the SLL carryback. They do establish a default rule that "[t]he Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application." Treas. Reg. § 1.1502-80(a) (as amended in 1997).

To determine the tax liability of an affiliated group under the regulations, it is first necessary to determine the

consolidated taxable income for the group. *Id.* § 1.1502-2(a) (as amended in 1996). Consolidated taxable income is determined under Treas. Reg. § 1.1502-11(a) (as amended in 1997) by taking into account the following items:

> 1. The STI of each group member; and
>
> 2. The following "consolidated" items: (a) the consolidated net operating loss deduction; (b) consolidated capital gain net income; (c) consolidated section 1231 net loss; (d) consolidated charitable contributions deduction; (e) consolidated section 922 deduction; (f) consolidated dividends received deduction; and (g) consolidated section 247 deduction.

A member's STI — which encompasses cases in which deductions exceed gross income (negative STI) and vice versa (positive STI) — is calculated pursuant to Treas. Reg. § 1.1502-12 (as amended in 1996). Each member computes its STI in a manner similar to a separate corporation computing taxable income, but with a number of modifications. For example, a member does not take into account the consolidated items specified in Treas. Reg. § 1.1501-11. *Id.* § 1.1502-12(h)-(n).

Section 1.1502-21A defines the CNOL deduction, one of the consolidated items to be taken into account in calculating taxable income, as the aggregate of the CNOL carryovers and carrybacks to the taxable year. *Id.* § 1.1502-21A(a) (as redesignated and amended by T.D. 8677, 1996-30 I.R.B. 7, 1996-2 C.B. 119). The aggregate carryovers and

carrybacks consist of the group's CNOLs that may be carried back or over to the taxable year pursuant to I.R.C. § 172(b). *Id.* § 1.1502-21A(b)(1). The group's CNOL is calculated in a manner analogous to computing consolidated taxable income, taking into account: (1) the STI of each group member; (2) consolidated capital gain net income; (3) consolidated section 1231 net loss; (4) consolidated charitable contributions deduction; (5) consolidated dividends received deduction; and (6) consolidated section 247 deduction. *Id.* § 1.1502-21A(f).

To assess Intermet's position, the consolidated return regulations direct us first to determine whether the group, as opposed to its individual members, satisfies the Code's requirements for the SLL carryback. *See* Treas. Reg. § 1.1502-80(a). We find that Intermet does satisfy these requirements. First, for purposes of this appeal, we will assume that Lynchburg's claimed expenses satisfy the definition of SL expenses under I.R.C. § 172(f)(1)(B) since the Tax Court did not decide this issue. Second, there is no dispute that the "taxpayer" — Intermet — had a CNOL in 1992. Third, Lynchburg's SL expenses were "taken into account" in calculating Intermet's CNOL because they directly affected Lynchburg's STI which, in turn, affected Intermet's CNOL. Indeed, Lynchburg's SL expenses reduced Lynchburg's STI and increased Intermet's CNOL dollar-for-dollar. Finally, Intermet was entitled to carry back the full amount of Lynchburg's SL expenses because those expenses did not exceed Intermet's CNOL for the year.

The IRS argues that Intermet does not satisfy the Code's requirements because it is improper to equate the Code's

references to "net operating loss" with Intermet's CNOL. We disagree. It is true that a group's CNOL is calculated somewhat differently than an individual corporation's NOL. But this is not dispositive. The consolidated return regulations tell us to apply the IRC provisions to "the group," and the CNOL represents the group's version of NOL. Moreover, the IRS has consistently taken the position — both in this case and otherwise — that the CNOL does have significance in applying the SLL carryback in the consolidated return context because only a group with a CNOL may take advantage of the carryback. *See* Tech. Adv. Mem. 9715002 (Apr. 11, 1997).

Having concluded that Intermet satisfies the statutory requirements for the SLL carryback, we next consider whether the consolidated return regulations somehow alter this result. *See* Treas. Reg. § 1.1502-80(a). Although the regulations do not explicitly address the SLL carryback, the IRS insists that the overall structure of those regulations preclude Intermet from taking advantage of the SLL carryback. Like the Tax Court, the IRS points out that the regulations require group members to deduct SL expenses in calculating their STI, since SL expenses do not appear on the list of "consolidated" items for purposes of calculating the group's taxable income. According to the IRS, in a case where the member incurring SL expenses also has a positive STI, the SL expenses "cannot give rise to any [CNOL] for the consolidated group, since those [expenses] are entirely absorbed by the income of the member before any consolidated item for the group is even computed." In other words, the IRS takes the position that Lynchburg's SL expenses were not "taken into account" in calculating

Intermet's CNOL because Lynchburg's positive STI "eliminated" the SL expenses. On the other hand, the IRS asserts that a member's SL expenses are taken into account in a CNOL if the member has a negative STI because the expenses are "not entirely absorbed at the member level."

While we agree with the IRS's overall description of the consolidated return regulations, we reject its analysis. A member's STI is simply a step along the way to calculating the group's taxable income or CNOL. An STI has no other purpose. More to the point, the regulations prescribing the calculation of STI and CNOL do not govern the determination of CNOL carrybacks. That issue is governed by Treas. Reg. § 1.1502-21A(b), which applies the carryback principles of section 172 to the consolidated NOL of the group, rather than separate member "NOLs" or STIs, in situations such as this one, which do not involve separate return years. In addition, the IRS and the Tax Court perceive a distinction between positive and negative STI that is unsupported by the regulations. An STI's character as positive or negative has no independent significance — either for purposes of calculating CNOL or otherwise. A member's SL expenses affect the group's CNOL dollar-for-dollar, and it makes no difference whether the member has a positive or negative STI. Because neither the purpose nor the language of the consolidated return regulations provide a basis for concluding that the member's SL expenses are "exhausted" when the member has a positive STI but remain when the member has a negative STI, we find that the IRS's interpretation is unreasonable.

Our conclusion is fortified by the IRS's history of adopting or applying differing interpretations of the SLL

carryback in the consolidated return context. Such inconsistency, while not determinative, is a factor we consider in assessing whether an agency interpretation of its regulations is "reasonable." *See Martin*, 499 U.S. at 157-58; *Martin*, 5 F.3d at 146. We have identified at least two inconsistencies that undermine the IRS's analysis.

First, in a 1997 Technical Advice Memorandum, the IRS adopted an interpretation of the consolidated return regulations that differs from its analysis in this case. Tech. Adv. Mem. 9715002 (Apr. 11 1997). The Memorandum addressed the precise issue presented here — *i.e.*, "[w]hether specified liability expenses incurred by a member of a consolidated group may be carried back when that member has positive taxable income for the year in which the expenses are incurred." *Id.* While the IRS answered that question in the negative, as it does in this case, it offered different reasoning. Specifically, the IRS reasoned that a group is entitled to the SLL carryback only to the extent that the SL expenses do not exceed the "portion of the [CNOL] attributable to a member" that incurred the SL expenses. *Id.* According to the IRS, the "portion of the [CNOL] attributable to a member" must be calculated under the formula prescribed by Treas. Reg. § 1.1502-79(a)(3) (as amended in 1996). *Id.*

Even if we assume the Memorandum is reconcilable with the IRS's position in this case because a portion of the CNOL cannot be attributed to a member with a positive STI under Treas. Reg. § 1.1502-79(a)(3), the Memorandum's reliance on this regulation is entirely misplaced. Section 1.1502-79(a) (redesignated as Treas. Reg. § 1.1502-79A(a) by T.D. 8677)

establishes a method for allocating CNOL to an individual member if a member seeks to carry back a loss to a "separate return year," *i.e.*, a year in which the member was not part of the consolidated group. The IRS contends that this allocation method may also apply in cases such as this one that involve carrybacks to a consolidated return year, pointing out that section 1.1502-79(a)(3) does not explicitly limit its application to separate return years. Tech. Adv. Mem. 9715002.

The IRS's interpretation ignores a "fundamental rule of statutory construction that statutory language is to be read in pertinent context rather than in isolation." *Oates v. Oates*, 866 F.2d 203, 206 (6th Cir. 1989). When reading section 1.1502-79A(a) as a whole, there is no question that it applies only to the separate return scenario. Section 1.1502-79A is entitled "separate return years"; subsection (a) is entitled "carryover and carryback of consolidated net operating losses to separate return years"; and subsection (a), including its illustrative examples, addresses only situations involving separate return years. Indeed, the IRS has recognized in the past that "although the [CNOL] is apportioned to individual members for purposes of carry backs to separate return years, the apportioned amounts are not separate NOLs of each member." 49 Fed. Reg. 30528, 30530 (1984) (preamble to Prop. Treas. Reg. § 1.1502-21(g)). We note that the Fourth Circuit recently held that a consolidated taxpayer is entitled to a "product liability loss" carryback — comparable to the SLL carryback — for that portion of an individual member's product liability expenses that does not exceed the member's "separate net operating loss" as calculated under section 1.1502-79A(a)(3). *United Dominion Indus., Inc. v. United*

States, __ F.3d __, 2000 WL 305134, at *8-9 (4th Cir. March 24, 2000). The court offered no analysis to support its conclusion that Treas. Reg. § 1.1502-79A(a)(3) dictates a method for calculating a member's "separate net operating loss" outside of the separate return context. *Id.* at *8, n.17. For the reasons outlined above, we are unpersuaded by the Fourth Circuit's approach.

A second inconsistency also arises out of the 1997 Technical Advice Memorandum. The IRS maintained in the Memorandum that Treas. Reg. § 1.1502-80, which applies the Code provisions to the group to the extent that the regulations do not exclude such application, actually supports its position. Tech. Adv. Mem. 9715002. The IRS reasoned that the Code's SLL provision applies on a separate member basis, rather than a consolidated basis, because the provision refers to "the taxpayer," and such language generally means individual members in the consolidated return context. *Id.* In contrast, the IRS in the instant cases ignores the section 1.1502-80 default rule. More importantly, the IRS has consistently and correctly referred to Intermet — not Lynchburg — as the "taxpayer" in this appeal.

We recognize that a Technical Advice Memorandum is not binding upon either the IRS or this court. *See* I.R.C. § 6110(j)(3) (1994). But the Memorandum illustrates the IRS's application of the SLL carryback in the consolidated return context — history that we may consider in determining whether the IRS's current position is reasonable. *See Wolpaw v. Commissioner*, 47 F.3d 787, 792 (6th Cir. 1995). We also understand that the IRS's basic position — that a consolidated group cannot invoke the SLL carryback if the

SL expenses are incurred by a member with a positive STI — has remained unchanged. However, the IRS's shifting and incongruous reasoning in reaching this result highlights the fundamental flaw: its position does not comport with the current purpose and language of the Code and regulations. It is trying to fit a square peg into a round hole.

We also reject the IRS's contention that Intermet will reap a "double tax benefit" if it uses SL expenses both to offset Lynchburg's positive STI and to extend the carryback period from three years to 10 years. Again, the IRS errs by attributing independent significance to the STI that does not exist. By offsetting part of Lynchburg's positive STI, the SL expenses produced no tax benefit whatsoever. Intermet — not Lynchburg — was the taxpayer for 1992. Intermet derived no tax benefit from the SL expenses in 1992 because Intermet had a CNOL exceeding $25 million and incurred no tax liability whatsoever in that year. Thus, the SL expense deductions produced only a single tax benefit — the ability to carry back those expenses to prior tax years.

In closing, we note the lack of any controlling judicial authority on the issue we decide here. Apart from the Fourth Circuit's recent opinion in *United Dominion*, which we have already discussed, the parties and the Tax Court identified two published opinions addressing arguably analogous issues: *Amtel, Inc. v. United States*, 31 Fed. Cl. 598 (1994), *aff'd*, 1995 WL 364366 (Fed. Cir. June 19, 1995) (unpublished disposition), and *Norwest Corp. and Subsidiaries v. Commissioner*, 111 T.C. 105 (1998). We find these cases to be distinguishable, however. Explicit statutory or regulatory provisions supported the separate member

approach that the courts adopted in *Amtel* and *Norwest*, rendering inapplicable the default rule in Treas. Reg. § 1.1502-80(a) that guides our analysis here. In summary, we conclude that the IRS's interpretation of the SLL carryback, in conjunction with the consolidated return regulations, is unreasonable. Intermet is entitled to the SLL carryback for Lynchburg's claimed SL expenses provided that those expenses qualify as a specified liability loss under I.R.C. § 172(f)(1)(B).

IV.

For the foregoing reasons, we **REVERSE** the judgment of the United States Tax Court and **REMAND** to that court for further proceedings consistent with this opinion.

APPENDIX F — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT DENYING PETITION FOR REHEARING IN *INTERMET CORPORATION & SUBSIDIARIES v. COMMISSIONER OF INTERNAL REVENUE* DATED AND FILED JUNE 1, 2000

Case No: 99-1046

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

ORDER

INTERMET CORPORATION & SUBSIDIARIES

Petitioner – Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent – Appellee

BEFORE: RYAN and SUHRHEINRICH, Circuit Judges; BELL, District Judge.*

Upon consideration of the petition for rehearing filed by the appellee,

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* The Honorable Robert Holmes Bell, United States District Judge for the Western District of Michigan, sitting by designation.

Appendix F

It is **ORDERED** that the petition for rehearing be, and it hereby is, **DENIED.**

ENTERED BY ORDER OF THE COURT

s/ Leonard Green
Leonard Green, Clerk

Supreme Court, U.S.
FILED
OCT 24 2000
CLERK

(2)

No. 00-157

In the Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

A "product liability loss" incurred by a corporation may be carried back a maximum of ten years from the loss year and used as a deduction in the carryback year. 26 U.S.C. 172(b)(1)(I) (1988); see 26 U.S.C. 172(b)(1)(C), (f). The question presented in this case is whether, under the Treasury regulations that govern the year in which this case arose, the availability of the "product liability loss" carryback for affiliated entities that file a consolidated return is to be determined by (i) aggregating the income and expenses of the consolidated entities or, instead, (ii) separately calculating the income and expenses of each entity.

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In the Supreme Court of the United States

No. 00-157

UNITED DOMINION INDUSTRIES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-24a) is reported at 208 F.3d 452. The opinion of the district court (Pet. App. 25a-41a) is unofficially reported at 98-2 U.S. Tax Cas. (CCH) ¶ 50,527.

JURISDICTION

The judgment of the court of appeals was entered on March 24, 2000. The petition for rehearing and for rehearing en banc was denied on May 19, 2000 (Pet. App. 42a). The petition for a writ of certiorari was filed on July 28, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

1. The applicable provisions of Section 172 of the Internal Revenue Code, 26 U.S.C. 172 (1988), and of the regulations that govern the filing of consolidated returns, 26 C.F.R. 1.1502 (1986), are set forth at Pet. 1-3 and Pet. App. 43a-59a.

2. 26 U.S.C. 11(a) provides:

> A tax is hereby imposed for each taxable year on the taxable income of every corporation.

3. 26 U.S.C. 1501 provides, in relevant part:

> An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. * * *

4. 26 U.S.C. 1502 provides:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability

and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

STATEMENT

1. Petitioner is the successor in interest of the common parent of an affiliated group of corporations that filed consolidated federal income tax returns for the taxable years 1983-1986. Pet. App. 3a. By filing a consolidated return, these corporations "consent[ed] to all the consolidated return regulations prescribed under section 1502 [of the Internal Revenue Code] prior to the last day prescribed by law for the filing of such return." 26 U.S.C. 1501. The statute broadly authorizes the Secretary to adopt such consolidated return regulations as he "may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group * * * may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability * * * and in order to prevent avoidance of such tax liability." 26 U.S.C. 1502.

The affiliated corporations that joined in the consolidated return included Jesco, Inc., Cherry-Burrell Corporation, Amtel, Inc., The Litwin Corporation and Litwin Panamerican Corporation. Pet. App. 3a. Petitioner reported consolidated net operating losses for each of the years from 1983 to 1986. While all of the affiliates named above incurred product liability expenses in each of those years, either some or all of them had a positive "separate taxable income" (under 26 C.F.R. 1.1502-12) during those years. Pet. App. 27a. The issue in this case is whether the product liability expenses incurred by the affiliates that had positive

separate income during these years constitute "product liability losses" under 26 U.S.C. 172(b)(1)(I) (1988) that may be carried back ten years and used as deductions from petitioner's consolidated taxable income for the taxable years 1973-1976.[1] The Internal Revenue Service determined that the product liability deductions claimed by the affiliates during the years that they had positive separate taxable incomes did not constitute "product liability losses" for purposes of Section 172 that could be carried back for the ten-year period authorized by that statute. Pet. App. 28a. The Service therefore denied petitioner's refund claims for the 1973-1976 consolidated return years. *Ibid.*

2. Petitioner thereafter brought a refund suit in the United States Court of Federal Claims, asserting that the product liability deductions claimed by its affiliates during 1985 created a product liability loss that could be carried back ten years and deducted from the gross income reported on their consolidated return for 1975. In that case, petitioner contended that the Amtel group was entitled to the carryback on the theory that "a consolidated group is treated as a single entity with respect to the product liability provisions." *Amtel, Inc.* v. *United States*, 31 Fed. Cl. 598, 599 (1994), aff'd, 59 F.3d 181 (Fed. Cir. 1995).[2] The Court of Federal Claims

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[1] The provisions formerly located at Section 172(b)(1)(I) have been relocated at Section 172(b)(1)(C), (f). See 26 U.S.C. 172(b)(1)(C), (f).

[2] In 1975, Amtel was the common parent of an affiliated group of corporations that included Litwin and Panamerican. Those corporations were not members of petitioner's affiliated group in that year. The consolidated return regulations accompanying Section 1502 of the Code denominate the 1975 taxable year a "separate return year" for Amtel, Litwin and Panamerican. See 26 C.F.R. 1.1502-1(e).

held, however, that "Amtel cannot carry back a product liability loss from 1985 to 1975 because it had no net operating loss in 1985." 31 Fed. Cl. at 600. The court noted that, under the governing consolidated return regulations (26 C.F.R. 1.1502-79(a)(3)), Amtel had no separate loss for 1985 to carry back to its 1975 separate return year. 31 Fed. Cl. at 601. The court rejected the argument that a "consolidated product liability loss" should be computed for petitioner for 1985 because the consolidated return "regulations do not use the term 'consolidated product liability loss' or incorporate such a concept by directing that product liability loss be treated on a consolidated basis." 31 Fed. Cl. at 602. The Federal Circuit affirmed the decision of the Court of Federal Claims in an unpublished opinion. 59 F.3d 181 (1995) (Table).

3. After the Federal Circuit issued its opinion in *Amtel*, petitioner filed this second refund suit in the United States District Court for the Western District of North Carolina, again contending that product liability deductions claimed by its affiliates during 1983, 1984, 1985 and 1986 created product liability losses that could be carried back ten years and deducted from petitioner's consolidated taxable income for 1973, 1974, 1975 and 1976. Pet. App. 28a. The complaint sought a refund of $1,618,305 plus statutory interest. J.A. 15.

The district court granted petitioner's motion for summary judgment. Pet. App. 25a-41a. The court agreed with petitioner that an affiliated group's product liability loss carryback should be determined on a consolidated basis. *Id.* at 38a-39.[3]

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[3] The district court also held that the decision in *Amtel* did not collaterally estop petitioner from asserting that product liability losses must be accounted for on a consolidated basis. Pet. App.

4. The court of appeals reversed. Pet. App. 1a-23a. The court concluded that the consolidated return regulations "make clear * * * that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated 'product liability loss' is not intended." *Id.* at 16a. The court observed that, under the consolidated return regulations, "product liability expenses are linked to the consolidated net operating loss only through their nexus to the group member" (*ibid.*) and "that an interpretation removing the close nexus between such expenses and whether the affected company operated at a loss is inconsistent with the regulations." *Id.* at 17a. The court concluded "that determining 'product liability loss' separately for each group member is correct and consistent with the regulations." *Ibid.* The court explained the proper method for determining product liability loss on a consolidated return (*id.* at 21a):

> The regulations governing consolidated returns provide a simple and direct method for determining the portion of a group member's product liability expenses that are "product liability loss." The regulations define a group member's "separate net operating loss," *see* Treas. Reg. § 1.1502-79(a)(3), which is analogous to an individual's "net operating loss" on a separate return. By comparing each member's product liability expenses to its "separate net operating loss," that member's "product liability loss" may be properly calculated. The parent's "product liability loss" is then calculated as the total of the members' "product liability loss."

39a-40a. The United States did not raise the collateral estoppel issue in the court of appeals.

ARGUMENT

1. The court of appeals correctly concluded that petitioner is not entitled to use product liability expenses incurred by a profitable affiliate to generate "product liability losses" that may be carried back for the ten-year period authorized by Section 172 of the Internal Revenue Code, 26 U.S.C. 172. The Sixth Circuit, however, incorrectly reached the opposite conclusion in its recent decision in *Intermet Corporation* v. *Commissioner*, 209 F.3d 901 (2000). There is thus a conflict among the circuits on a matter of substantial recurring importance in tax administration.

Under Section 1501 of the Code, the Treasury has the authority and responsibility to adopt consolidated return regulations that, when adopted, would effect a binding resolution of this matter. Section 1501 specifies that affiliated corporations may file a consolidated return only "upon the condition that * * * the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return." 26 U.S.C. 1501. In turn, Section 1502 authorizes the Secretary to "prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group" be properly determined "in such manner as clearly to reflect the income tax liability" of those entities. 26 U.S.C. 1502. Congress has thus vested ample authority in the Secretary to adopt binding regulations to govern the treatment of consolidated returns. Once such binding regulations are adopted, any taxpayer who files a consolidated turn "shall be considered" as having consented to them. 26 U.S.C. 1501.

When, as in this case, an agency has been directed to resolve controversial applications of a statute by regulation, this Court has stated that it is "more restrained and circumspect in using [the] certiorari power as the primary means of resolving [circuit] conflicts." *Braxton* v. *United States*, 500 U.S. 344, 348 (1991). Nonetheless, the regulations adopted by the Secretary under Section 1502 are binding on taxpayers only if they are in effect "prior to the last day prescribed by law for the filing" of the taxpayer's consolidated return. 26 U.S.C. 1501.[4] Accordingly, while the Secretary remains fully empowered to resolve the existing controversy prospectively, it appears that only this Court could now resolve the existing conflict among the circuits for past years.

The Internal Revenue Service advises us that the question presented in this case is currently pending in more than 100 cases at the administrative level. Moreover, for all years that precede any prospective administrative clarification of the governing regulations—a clarification that is now only at the earliest stages of consideration—the question presented here is likely to arise in numerous cases. In this situation, we do not oppose the grant of certiorari in this case.

2. a. A "net operating loss" is defined as "the excess of the deductions * * * over the gross income" of the taxpayer. 26 U.S.C. 172(c).[5] "A taxpayer does not have

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[4] See also 26 U.S.C. 1503 (whenever a consolidated return is filed, "the tax shall be determined * * * in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of such return").

[5] Unless otherwise noted, the statutory references in this brief are to the Internal Revenue Code as in effect between 1983 and 1986.

a [net operating] loss for a particular year unless its deductions exceed its ordinary income and its capital gains." *United States* v. *Foster Lumber Co.*, 429 U.S. 32, 47 (1976). Under Section 172 of the Code, a taxpayer is generally allowed to carry back net operating losses for three years from the year in which the loss was incurred. 26 U.S.C. 172(b)(1)(A). Section 172(b)(1)(I) of the Code, however, provides an exception from the general rule that allows "product liability losses" to be carried back for a period of ten years. 26 U.S.C. 172(b)(1)(I).[6] The term "product liability loss" is defined to mean "the lesser of" the "net operating loss for such year" and the deductible expenses incurred by the entity that are "attributable to" the satisfaction or defense of product liability claims. 26 U.S.C. 172(j)(1).[7] A taxpayer thus has a "product liability loss" for a particular taxable year only if (i) the taxpayer has a net operating loss for the year (*i.e.*, its total deductions exceed its gross income) *and* (ii) the net operating loss is attributable in whole or in part to deductions for product liability expenses.[8]

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[6] The ten-year carryback period for product liability losses is now provided by Sections 172(b)(1)(C) and 172(f)(1)(A) of the Code. 26 U.S.C. 172(b)(1)(C), (f)(1)(A) (1994 Supp.).

[7] The term "product liability" is defined as (26 U.S.C. 172(j)(2)):

> liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if * * * such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

[8] The Internal Revenue Code generally defines a "taxpayer" as "an individual, a trust, estate, partnership, association, com-

b. This case concerns the proper application of the product liability loss provisions to an affiliated group of corporations that files a consolidated return. When an affiliated group of corporations files a consolidated return, "the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of such return." 26 U.S.C. 1503. The consolidated return regulations promulgated by the Treasury pursuant to Section 1502 are designed to arrive at a single figure of income or loss for the affiliated group for the consolidated return year. This figure, which is denominated "consolidated taxable income" under the regulations, is determined by taking into account the "separate taxable income" of each member of the affiliated group. 26 C.F.R. 1.1502-11 (1986). Subject to specific exceptions, the regulations provide that "[t]he separate taxable income of a member * * * is

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pany, or corporation." 26 U.S.C. 7701(a)(1) and (14). Section 7701(a)(1) provides that "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—[t]he term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." Section 7701(a)(14) provides that "[t]he term 'taxpayer' means any person subject to any internal revenue tax." An affiliated group of corporations that files a consolidated return is generally not treated as a "taxpayer" for purposes of the Internal Revenue Code because an affiliated group is defined as "1 or more chains of includible corporations connected through stock ownership with a common parent corporation, which is an includible corporation * * *." 26 U.S.C. 1504(a). Thus, the "taxpayer" referred to in Section 172(b)(1)(I) is a corporation that files a separate return, reports a net operating loss, and claims product liability deductions; the term does not encompass an affiliated group of corporations.

computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations * * *." 26 C.F.R. 1.1502-12 (1986).[9] The "net operating loss deduction" available for the consolidated entity is thus determined in the same manner as the group's consolidated taxable income: each member of the group computes its separate taxable income or loss and, with specific adjustments, these separate figures are then aggregated into a single figure constituting the consolidated taxable income.[10] If

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[9] The "separate taxable income" computed by a member of an affiliated group is not necessarily equivalent to the income or net operating loss figure that the corporation would have computed had it filed a separate return. It is possible for a corporation to compute positive separate taxable income even though the corporation would have reported a net operating loss had it filed a separate return. For example, if a corporation made a charitable contribution during a particular year, it could conceivably have had a "net operating loss" under Section 172 even though it computed positive separate taxable income under the consolidated return regulations, because the charitable contributions deduction is not taken into account in the computation of separate taxable income. Conversely, it is possible for a corporation to compute negative separate taxable income even though it would have reported positive income had it filed a separate return. Nothing in the record of this case, however, suggests that any member of petitioner's affiliated group that computed positive separate taxable income and claimed product liability deductions would have had a "net operating loss" under Section 172 had it filed a separate return.

[10] Under the regulations, the "net operating loss deduction" available for the consolidated entity is defined as "an amount equal to the aggregate of the consolidated net operating loss carryovers and carrybacks to the taxable year (as determined under paragraph (b) of this section)." 26 C.F.R. 1.1502-21(a) (1986). In turn, paragraph (b) provides that "[t]he consolidated net operating loss carryovers and carrybacks to the taxable year shall consist of any consolidated net operating losses (as determined under paragraph

a consolidated net operating loss results from these calculations, it may then be carried back (or forward) under Section 172 to other taxable years for which the affiliated group reported taxable income.

c. Petitioner errs in claiming that an affiliated group that reports a consolidated net operating loss for a particular year necessarily has a product liability loss for the year equal to the sum of the product liability expense deductions claimed by its members. See Pet. App. 11a. Under the regulations described above, each group member must initially compute its product liability loss (if any) on an individual basis, and the resulting figures are then to be aggregated to arrive at the total loss for the group.[11] The court of appeals correctly held (Pet. App. 17a) that petitioner's contrary approach is at odds with these regulations.

In particular, the consolidated return regulations require the consolidated net operating loss deduction to be computed by aggregating the separate taxable income of each of the affiliates. 26 C.F.R. 1.1502-21(f) (1986). The individual members of the group are initially to compute their "separate taxable incomes," those figures are to be aggregated into a single amount, and this amount is then adjusted by taking into account

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(f) of this section) of the group, plus any net operating losses sustained by members of the group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b)." 26 C.F.R. 1.1502-21(b) (1986). And, in turn, paragraph (f) provides that "the consolidated net operating loss shall be determined by taking into account * * * [t]he separate taxable income * * * of each member of the group * * *." 26 C.F.R. 1.1502-21(f) (1986).

[11] Petitioner is simply wrong in suggesting that "the IRS itself has favored single-entity treatment in the past" (Pet. 14). In fact, the Service has never endorsed that approach.

the consolidated items delineated in the regulation. *Ibid.* The consolidated items listed in the regulation do *not* include deductions attributable to product liability expenses. See *ibid.* Deductions for product liability expenses therefore must be applied in the first instance against the gross income of each affiliate in computing its "separate taxable income" under the regulations. Because the deductions are applied against the income of the individual affiliates, they cannot be treated separately from the corporation that claimed them. As the court of appeals correctly concluded, the requirement of the consolidated return regulations that a "separate taxable income" be computed for each affiliate "makes clear that blending those expenses is not permitted, i.e., that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated 'product liability loss' is not intended." Pet. App. 16a. The court of appeals properly rejected petitioner's claim in this case, for petitioner failed to sustain its "burden of clearly showing the right to the claimed deduction" under the regulations. *Indopco, Inc.* v. *Commissioner*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943)).[12]

3. In *Intermet Corporation* v. *Commissioner*, *supra*, the Sixth Circuit resolved the question presented in this case in favor of the taxpayer. Pet. App. 60a-76a.

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[12] Petitioner's criticism of the court's method of computing the "product liability loss" for specific individual members of the affiliated group (Pet. 12) is irrelevant to the legal issue presented in this case. There is no evidence in the record that any individual member of petitioner's affiliated group would have a "product liability loss" under any method of calculating such a loss at the individual level. See note 9, *supra*.

Although the court stated in *Intermet* that the consolidated return "regulations do not specifically address the application of the [loss] carryback" (*id.* at 67a), the court ultimately concluded that this issue was properly resolved by a portion of the regulations that neither party had cited. That regulation is 26 C.F.R. 1.1502-80(a), which specifies that "[t]he Internal Revenue Code, or other law, shall be applicable to the [consolidated] group to the extent the regulations do not exclude its application." The court stated that this regulation requires an affiliated group of corporations to be treated as a single taxpayer for purposes of the Internal Revenue Code unless the consolidated return regulations mandate a different result. Pet. App. 69a. The court in *Intermet* reasoned that, because the consolidated return regulations mandate no specific result in this situation, the entire affiliated group must be treated as a single "taxpayer" for purposes of Section 172(f). Pet. App. 69a. The court concluded that nothing in the regulations modified "the default rule" in 26 C.F.R. 1.1502-80(a) under which the consolidated group was to be treated as if it were a single taxpayer. Pet. App. 74a.

The Sixth Circuit erred in its construction of this regulation, which simply specifies that the usual rules found in the Internal Revenue Code or other sources of law apply to an affiliated group of corporations unless the consolidated return regulations provide a different rule. 26 C.F.R. 1.1502-80(a). The relevant "default" rule thereby incorporated into the consolidated return regulations is that every separate corporation is to be treated as a separate taxable entity (unless the consolidated return regulations otherwise provide). See 26 U.S.C. 11(a); *Moline Properties* v. *Commissioner*, 319 U.S. 436, 439-440 (1943); *In re Chrome*

Plate, Inc., 614 F.2d 990, 996 (5th Cir. 1980). The "default" rule provided by the regulation thus requires members of an affiliated group to be treated as *separate* entities when applying provisions of the Internal Revenue Code *unless* the consolidated return regulations provide for treatment of the group as a single entity. See *Gottesman & Co.* v. *Commissioner*, 77 T.C. 1149, 1156 (1981); *H Enterprises International, Inc.* v. *Commissioner*, 105 T.C. 71, 85 (1995). The court of appeals erred in *Intermet* by giving the regulation an interpretation that simply stands its plain text upside down.

There is, as we have noted, no evidence in the record of this case that any member of petitioner's affiliated group would have had a product liability loss under Section 172(j) if it had filed a separate return during the years in issue. See note 12, *supra*. Applying the "default" rule of 26 C.F.R. 1.1502-80(a) to this case therefore requires rejection, rather than acceptance, of petitioner's claim.

CONCLUSION

For the reasons stated above, the United States does not oppose the granting of the petition for a writ of certiorari.

Respectfully submitted.

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IN THE

Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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QUESTION PRESENTED

Section 172(b)(1)(I) of the Internal Revenue Code of 1954 allows a taxpayer with a "product liability loss," as defined in section 172(j)(1), to carry that loss back up to a maximum of 10 years from the year in which the loss is incurred, to be deducted from income in the earlier year. The issue in this case is whether, in the case of an affiliated group of corporations filing a consolidated federal income tax return, a product liability loss is determined on a consolidated basis, as the petitioner contends, or on some type of a separate company-by-company basis, as the respondent contends.

LIST OF PARTIES AND CORPORATE DISCLOSURE STATEMENT

All parties to the proceeding in the court whose judgment is under review are named in the caption of the case in this Court. Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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OPINIONS BELOW

The opinion of the Court of Appeals (Pet. App. A[1]), *United Dominion Indus., Inc. v. United States*, is reported at 208 F.3d 452 (4th Cir. 2000). The District Court opinion (Pet. App. B), *United Dominion Indus., Inc. v. United States*, is unofficially reported at 98-2 U.S.T.C. (CCH) ¶ 50,527 (June 9, 1998).

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on March 24, 2000. The Court of Appeals entered an order denying a timely petition for rehearing and suggestion for rehearing en banc on May 19, 2000. (Pet. App. C.) Petitioner filed its Petition for a Writ of Certiorari on July 28, 2000.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves sections 172(b)(1)(I), 172(c), and 172(j)(1) of the Internal Revenue Code of 1954, ("the Code"),[2] 26 U.S.C § 1 *et seq.*, and sections 1, 11, 12, 21, 75, and 79 of the consolidated return regulations,

1. All references to "Pet. App." are to the Appendix submitted by petitioner with its Petition for a Writ of Certiorari.

2. All references to the Code are references to the Internal Revenue Code of 1954, 26 U.S.C. § 1 *et seq.*, as in effect during the years 1983 through 1986, unless otherwise stated.

Treas. Reg. § 1.1502.[3] Because these regulations are lengthy, they are set forth separately in Pet. App. D.

For the years in question, section 172(b)(1)(I) provides the following:

> (I) PRODUCT LIABILITY LOSSES. — In the case of a taxpayer which has a product liability loss (as defined in subsection (j)) for a taxable year beginning after September 30, 1979 (referred to in this subparagraph as the "loss year"), the product liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the loss year.

Section 172(j)(1) defines the term "product liability loss" as follows:

> (1) PRODUCT LIABILITY LOSS. — The term "product liability loss" means, for any taxable year, the lesser of —
>
> > (A) the net operating loss for such year reduced by any portion thereof which is attributable to a foreign expropriation loss, or
> >
> > (B) the sum of the amounts allowable as deductions under sections 162 and 165 which are attributable to —

---

3. All references to "Treas. Reg. §" are references to these regulations, 26 C.F.R. § 1502-1 *et seq.*, as in effect during the years 1983 through 1986, unless otherwise stated.

> (i) product liability, or
>
> (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

Section 172(c) defines the term "net operating loss," in pertinent part, as follows:

> (c) NET OPERATING LOSS DEFINED. — For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income.

STATEMENT OF THE CASE

This case involves the interplay between the rules governing net operating losses under section 172 of the Internal Revenue Code of 1954 and the consolidated return regulations issued by the Internal Revenue Service ("IRS") under the authority of section 1502 of the Code.

As a general matter, if a taxpayer properly claims deductions in a year that exceed the gross income it generates, it is said to have a "net operating loss" (*see* section 172(c) of the Code) that it is entitled to carry back to preceding taxable years as an offset to the taxable income generated in those years, thereby yielding a refund of taxes. The main reason for this provision is to smooth the taxpayer's income and loss over multiple tax accounting periods.

A taxpayer ordinarily is permitted to carry its net operating loss back to the third year[4] preceding the year in which it incurred the loss, and then, if the loss is not fully absorbed in that year, to the second preceding year, the first preceding year (sec. 172(b)(1)(A) of the Code), and then forward for as many as 15[5] years (sec. 172(b)(1)(B) of the Code).

In the case of a "product liability loss," the statute extends the carryback period from the three years preceding the loss year to the 10 years preceding the loss year. (Sec. 172(b)(1)(I) and sec. 172(j)(1) of the Code.) Congress provided this extended carryback period primarily because it understood that the latent cost of product liability can take years to emerge, rendering the normal three-year matching period insufficient. *See* Staff of the Joint Comm. On Tax'n, 95th Cong., General Explanation of the Revenue Act of 1978, 232 (Comm. Print 1979). The 10-year carryback has been a part of the federal income tax law since 1979. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 371, 92 Stat. 2763, 2859. This case involves the application of this extended carryback provision to an affiliated group of corporations filing a consolidated federal income tax return.

In 1990, Congress reorganized section 172 and made the term "product liability loss" a subcategory of the term "specified liability loss" in section 172(b)(1)(C) and (f) of the Internal Revenue Code of 1986. *See* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11811,

4. The carryback period was reduced to two years in 1990, after the years in issue in this case.

5. The carryforward period was extended to 20 years in 1990 when the carryback period was reduced from three years to two years.

104 Stat. 1388, 1388-530. This reorganization did not change the meaning of the term "product liability loss," but simply brought under one subsection all types of expenses then entitled to the 10-year carryback. Although this change in the law has no specific application in this case, reference to it is made because of its applicability in *Intermet Corp. v. Commissioner,* 209 F.3d 701 (6th Cir. 2000) (Pet. App. E), the decision that is in direct conflict with the decision of the Court of Appeals in this case.

Under section 1501 of the Code, a common parent corporation and its subsidiary corporations, referred to as an "affiliated group," may elect to file a single consolidated federal income tax return. The sole issue in this case is whether an affiliated group of corporations properly computes its product liability loss as if it were a single entity, as United Dominion contends, or whether each member of the group computes its product liability losses on some form of separate company basis, as the United States contends.

During the years 1973 through 1986, United Dominion operated under the name of AMCA International Corporation ("AMCA"). (Pet. App. A at 2a, n.1.) During these years, AMCA filed consolidated income tax returns with its affiliated subsidiaries pursuant to section 1501 of the Code, and in accordance with the regulations issued by the IRS under the authority granted to it under section 1502. (Pet. App. A at 3a.) The Code is largely silent with respect to the rules affecting affiliated groups of corporations, and these rules are primarily found in the extensive regulations issued under section 1502.

The consolidated return regulations allow the income of one or more members of the group to be offset by losses

incurred by one or more other members of the group. Accordingly, the affiliated group computes its federal income tax on the basis of its consolidated taxable income or calculates its net operating loss on a consolidated basis. Treas. Regs. § 1.1502-2 and § 1.1502-21. In short, the affiliated group essentially computes its taxable income or its net operating loss as if it were a single company, and as if the members of the group were divisions of that company.

For the years 1983, 1984, 1985 and 1986, AMCA reported consolidated net operating losses of between $85 million and $140 million (Pet. App. B at 26a.) These amounts far exceeded the annual product liability expenses of all of the members of the AMCA consolidated group during these years, which ranged from approximately $3.5 million to $6.5 million. This case involves five members of the AMCA affiliated group that contributed the following combined amounts of product liability expenses to the group's total in each year in issue, all of which the Court of Appeal's decision excluded from AMCA's product liability loss:

YEAR	AMOUNT DISALLOWED
1983	$ 205,919.00
1984	$ 1,609,340.00
1985	$ 1,333,788.00
1986	$ 250,550.00

(Pet. App. B at 25a.[6])

6. The $1,618,306 figure used by the Court of Appeals (Pet. App. A at 3a) actually represents the total income tax refund in issue, not the amount of the product liability expenses which are in dispute, the amount of which was correctly stated in the opinion of the District Court.

Neither party disputes the size of these amounts or their characterization under section 172(j)(1)(B) as deductions attributable to product liability. This case focuses solely on whether the AMCA affiliated group can use these amounts in determining its product liability loss that is eligible for the 10-year carryback arising during the years 1983 through 1986. *The dispute arises because, in each of these years in which the AMCA group had a consolidated net operating loss, each one of the five companies in question,*[7] *when considered on a separate company basis, generated positive separate taxable income, as that term is defined under Treas. Reg. § 1.1502-12.*

The pivotal facts of this case (Pet. App. E at 61a-62a), thus are:

> 1. An affiliated group of corporations filing a consolidated federal income tax return has a large consolidated net operating loss resulting from the fact that the total deductible expenses of all members of the group exceed the total gross income of all members of the group;
>
> 2. Various members of the affiliated group incur expenses attributable to product liability that, in total, are less than the group's consolidated net operating loss for the year; and
>
> 3. Some members of the group incurring expenses attributable to product liability have positive separate taxable income for the year in which the product liability expenses are incurred.

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7. There are two minor exceptions of no consequence to this case. (Pet. App. A at 4a.)

Under the plain language of section 172(j)(1), a taxpayer's product liability loss is the amount of its deductible product liability expenses for a given year, limited by the amount of the taxpayer's net operating loss for that year. Thus, for example, if the taxpayer has a net operating loss of $100 and deductible product liability expenses of $80, the taxpayer has a product liability loss of $80. If the taxpayer does not have a net operating loss for a year, its product liability loss for the year is zero, regardless of the amount of the taxpayer's product liability deductions. The identical mechanism applies to specified liability losses.

In 1986 and 1987, petitioner filed with the IRS claims for refund with respect to its 1983 through 1986 consolidated tax returns. (Pet. App. B at 27a-28a.) In its claims, petitioner asserted that it was entitled, under section 172(b)(1)(I) of the Code, to carry back up to 10 years the amount of its product liability expenses incurred in 1983 through 1986. The amount of petitioner's claim at issue in this case is $1,618,306 of income tax, plus statutory interest.

The IRS agent assigned to review petitioner's claims for refund allowed the claims with respect to petitioner's consolidated return years. The agent allowed petitioner to carry back all of the product liability expenses it incurred during its 1983 through 1986 consolidated return years to offset its consolidated taxable income for the years 1973 through 1976. The agent agreed with petitioner that, for consolidated return years, the term "product liability loss" is determined on a consolidated, group-wide basis. (Pet. App. B at 28a.)

The Joint Committee on Internal Revenue Taxation of the United States Congress (which has jurisdiction over

refunds exceeding a certain threshold, as set forth in section 6405(a) of the Code) reversed the agent's decision and denied petitioner's claims. (Pet. App. B at 28a.) The Joint Committee determined that an affiliated group's "product liability loss" must be calculated at the level of each individual group member as if it had filed a separate corporate income tax return. Accordingly, the Joint Committee found that petitioner had no "product liability loss" to the extent the individual group members that incurred petitioner's product liability expenses did not have negative separate taxable income (even though the negative taxable income of a single group member is not equivalent either mechanically or in substance to a "net operating loss," as defined in section 172(c) of the Code).

As a result of the Joint Committee's denial of its claims for refund, petitioner filed a suit for refund of federal income taxes in the United States District Court for the Western District of North Carolina on August 24, 1995. In light of the absence of any factual dispute, the parties submitted cross-motions for summary judgment. In an order dated and filed June 19, 1998 (Pet. App. B), the District Court granted petitioner's motion for summary judgment and denied respondent's motion. The District Court correctly concluded that, with respect to consolidated return years, the amount of any 10-year carryback should be determined on a consolidated basis. (Pet. App. B at 38a-39a.) On September 14, 1998, the United States filed a notice of appeal.

On March 24, 2000, the Court of Appeals rejected the consolidated return approach of the District Court and reversed its judgment. Instead, the Court of Appeals determined that petitioner's entitlement to the ten-year carryback for consolidated return years should be determined on a separate, company-by-company basis. The Court of

Appeals based its erroneous conclusion largely upon Treas. Reg. § 1.1502-79(a) (Pet. App. at 21a), a provision having no function other than that of apportioning a consolidated net operating loss to separate return years of group members.[8] No separate return years are involved in this case.

On April 20, 2000, the Sixth Circuit Court of Appeals issued its opinion in the *Intermet*[9] case. (Pet. App. E.) The Sixth Circuit held that the amount of an affiliated group's specified liability loss qualifying for the 10-year carryback is properly determined on a consolidated basis, as the taxpayer in *Intermet* had argued. The Sixth Circuit rejected the argument of the United States that a specified liability loss had to be determined on a separate company basis, and specifically noted that it was "unpersuaded by the Fourth Circuit's approach." (Pet. App. E at 74a.)

SUMMARY OF THE ARGUMENT

During the years in issue, the AMCA affiliated group filed consolidated federal income tax returns reflecting net operating losses for the entire group. Because there is no

---

8. A separate return year of a member of a particular affiliated group is a year when the member filed a separate federal income tax return either for a year before or after it joined that particular group, or a year when such member joined in the filing of a consolidated return with another affiliated group.

9. *Intermet* involved specified liability expenses rather than product liability expenses, but that distinction is without legal significance because product liability expenses are identical to specified liability expenses with respect to the issue in this case.

such thing as a separate net operating loss for any separate member of an affiliated group, the group's net operating losses were calculated only on a group-wide, consolidated basis, in accordance with the regulations.

Section 172 of the Code provides that a taxpayer with a net operating loss may carry that loss back 10 years to the extent that the loss does not exceed the taxpayer's product liability deductions for that year. The portion of the taxpayer's net operating loss that may be carried back 10 years is called a "product liability loss." Because there is only one taxpayer with a net operating loss in this case — the AMCA affiliated group — this group is the only "taxpayer" which has (or could have) relevant product liability deductions.

This result flows from a number of sources. First, it follows logically and directly from both the plain language, as well as the technical operation, of the consolidated return regulations.

Second, it flows directly from the fundamental goal of the consolidated return regime to tax a family of affiliated corporations as if those corporations were one company, particularly with respect to the computation of net operating losses. The IRS has previously acknowledged as much in both a Private Letter Ruling (Priv. Ltr. Rul. 8816002) and in a notice the IRS released to the public in 1991 as it introduced proposed amendments to the consolidated return regulations.

Third, Congress plainly intended that the 10-year carryback rule of section 172 liberally benefit taxpayers by enlarging the number of years (from the normal three years to a total of 10 years) for which taxpayers could seek tax refunds as a result of incurring product liability losses.

The respondent's narrow reading of section 172(b)(1)(I) and (j)(1), as applied to an affiliated group of corporations, obstructs Congressional intent, and wrongly encourages corporate taxpayers to elevate tax planning over business planning when selecting the optimal organizational structures for their corporate families. If the respondent's position is adopted by the Court, corporate taxpayers will face little choice but to rearrange their corporate structures so that assets or operations that may potentially result in product liability expenses are placed within "unprofitable" corporate group members, because (according to the respondent) only product liability expenses of unprofitable members count toward the product liability loss of an affiliated group. Nothing in the Code or Regulations can be construed as supporting this manifestly undesirable result.

Fourth, as the Sixth Circuit correctly noted in *Intermet*, the reference in section 172(b)(1)(I) to a "taxpayer" is logically interpreted in the consolidated return context to mean the affiliated group itself, rather than individual members of the group. This conclusion follows irrefutably from the numerous group-oriented requirements set forth in the consolidated return regulations, including, among others, the rules requiring that (1) an affiliated group file a single tax return each taxable year (rather than the individual members filing separate returns); (2) the group's members each operate on an identical taxable year; and (3) the group, as a whole, computes a single annual tax liability or loss that takes into account a blended total of profitable members' incomes and unprofitable members' losses. The respondent's position that "taxpayer" means something other than the affiliated group in the consolidated return regulations is not supportable.

Fifth, the Court of Appeals below erroneously attached legal significance to the absence of an explicit reference to "consolidated product liability expenses" in the consolidated return regulations. Because the amount of an affiliated group's consolidated income or loss is the same whether one views product liability deductions on a group basis (as does petitioner) or on an individual member basis (as does respondent), there would never be a need under any circumstances for the consolidated regulations to reference a consolidated product liability expense item. Because the parties have no dispute over the amount of the AMCA group's consolidated net operating loss in any of the years in question, the only issue at stake concerns what portion of this agreed-upon loss can be carried back 10 years instead of the normal three years. The answer depends solely on the manner in which the group's product liability expenses are compared with AMCA's consolidated net operating loss, and Petitioner respectfully asserts that the only rational manner in which such expenses can be compared to an affiliated group's consolidated net operating loss is on a similar, consolidated basis.

Sixth, the Court of Appeals erroneously relied upon Treas. Reg. § 1.1502-79(a), a regulation which applies only to "separate return years," even though no such years are at issue in this case. By applying this inapplicable regulation, the Court of Appeals wrote a new judicial regulation which is at odds with the consolidated regulations' purpose and structure, the effect of which (if upheld) would be to distort the operation of section 172(b)(1)(I) and (j)(1), and to add unnecessary complications to an already complex area of tax law.

For the foregoing reasons, the AMCA group must be treated as a single taxpayer, both for the purpose of calculating its net operating loss, and also for the purpose of determining the amount of its 10-year product liability loss carrybacks. Because the AMCA group's consolidated net operating loss for each of the years 1983 through 1986 was larger than its total deductions attributable to product liability, the affiliated group's product liability loss for each of those years was equal to the sum of the deductions attributable to product liability incurred by all the members of its group. The affiliated group's product liability loss then became "a net operating loss carryback to each of the 10 taxable years preceding the loss year" under section 172.

A straightforward, logical application of the Code and the consolidated return regulations demonstrates that the decision of the Court of Appeals below should be vacated and the District Court's entry of summary judgment in favor of the Petitioner should be reinstated. Affirmance of the Court of Appeals' decision below not only would be incorrect as a technical matter, but it would encourage taxpayers to engage in inefficient, tax-motivated behavior that runs counter to sound tax policy.

ARGUMENT

A. The Mechanics Of The Consolidated Return Regulations Require That The Product Liability Losses Of An Affiliated Group Be Determined On A Single Entity Basis.

Section 172(j)(1) of the Code, the provision principally at issue in this case, unequivocally requires that a "taxpayer" have a "net operating loss" before it can have a "product

liability loss" eligible for the 10-year carryback. Under the consolidated return regulations in force during the years in dispute (as well as under the current regulations), a corporation that is a member of an affiliated group filing a consolidated federal income tax return can never have its own "net operating loss." The concept simply does not exist in the consolidated return context. In that context, only the affiliated group, as a single entity, can have a "net operating loss," which is defined as a "consolidated net operating loss" in Treas. Reg. § 1.1502-21(f). The attempt of the Fourth Circuit and the respondent to apply section 172(j)(1) at the separate corporate member level — despite the fact that no individual member of an affiliated group can ever have a net operating loss — is an unreasonable interpretation of that provision that should be rejected by this Court.

In order to understand the fundamental unsoundness of the Fourth Circuit's and the respondent's positions, one must carefully track through the related consolidated return regulations. Under Treas. Reg. § 1.1502-2, the tax liability of an affiliated group for a consolidated return year is determined by adding together a number of tax components, the first of which is

> The tax imposed by section 11 [of the Code] on the consolidated taxable income for such year (see § 1.1502-11 for the computation of consolidated taxable income).

Consolidated taxable income for a consolidated return year is determined under Treas. Reg. § 1.1502-11 by taking into account eight separate items. The first of these is

> [t]he separate taxable income of each member of the group (see § 1.1502-12 for the computation of separate taxable income).

The term "separate taxable income" is defined in Treas. Reg. § 1.1502-12 to include cases in which deductions exceed gross income. For this reason, this Brief uses the term "positive separate taxable income" to describe the separate taxable income of a member of an affiliated group with prescribed items of income in excess of prescribed deductions, and the term "negative separate taxable income" to describe the separate taxable income of a member of an affiliated group with prescribed deductions in excess of prescribed items of income. The unmodified term "separate taxable income" is used, as it is used in the consolidated return regulations, to describe either or both of these situations.

Under Treas. Reg. § 1.1502-11, items such as net operating loss carryovers, capital gains and losses, section 1231 losses and charitable deductions are taken into consideration on a consolidated basis only, separate and apart from the separate taxable income of each member of the group.

Under Treas. Reg. § 1.1502-12, each member of an affiliated group computes its own separate taxable income in much the same manner as a separate corporation would compute its taxable income, but with a number of important modifications. Thus, a member of the group, in computing its separate taxable income, does not take into account the net operating loss carryovers, capital gains and losses, § 1231 gains and losses, and charitable deductions that Treas. Reg. § 1.1502-11 requires to be computed on a consolidated basis only.

A consolidated net operating loss of an affiliated group is computed under Treas. Reg. § 1.1502-21(f) in a manner analogous to the computation of consolidated taxable income. *Treas. Reg. § 1.1502-21(f) is of the greatest significance in this case because it provides the exclusive definition in the regulations (there is no definition in the Code) of a net operating loss for an affiliated group of corporations.* Treas. Reg. § 1.1502-21(f) provides that "the consolidated net operating loss shall be determined by taking into account" six separately enumerated items. The first of these items is

> the separate taxable income (as determined under § 1.1502-12) of each member of the group. . . .

After taking into consideration the separate taxable income of each member of the affiliated group, the remaining items to be taken into consideration under Treas. Reg. § 1.1502-21(f), including capital gains and losses, section 1231 losses and charitable deductions, are all calculated on a consolidated basis only, wholly apart from "separate taxable income."

The fact that capital gains and losses, section 1231 losses and charitable contributions are excluded from the computation of "separate taxable income" necessarily means that "separate taxable income" can never reflect what an affiliated group member's taxable income or net operating loss would be if it filed a tax return as a separate company that was not part of an affiliated group. *Thus, when the calculation of a group member's "separate taxable income" under Treas. Reg. § 1.1502-12 produces a negative amount (prescribed deductions exceed prescribed income), that negative amount cannot, and does not, meet the definition of a net operating loss.* This is clear from the definition of

"net operating loss" in section 172(c) of the Code, which provides that

> the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income.

Inasmuch as capital losses, section 1231 losses and charitable deductions fall within the definition of "deductions allowed by this chapter," and capital gains are included in gross income, an amount computed without these items taken into account cannot be the equivalent of a net operating loss. In other words, a corporation that is a member of an affiliated group is incapable of having its own net operating loss under the consolidated return regulations, as recognized by the Court of Appeals. (Pet. App. A at 19a-20a.)

Section 172(b)(1)(I) of the Code provides that a taxpayer with a product liability loss may treat such loss as a net operating loss carryback to each of the 10 taxable years preceding the loss year. In order to determine the taxpayer's product liability loss, section 172(j)(1) requires that two items be compared. The first is a "net operating loss," and the second is "deductions . . . attributable to product liability." For an affiliated group, there is only a *consolidated* net operating loss; no individual member of the group can have its own net operating loss. It must follow that, if an affiliated group has only a consolidated net operating loss, and no member of the group can have a separate net operating loss, the thing to be compared with a net operating loss, namely, deductions attributable to product liability, can only be determined on a group-wide basis if the required comparison is to be made in a consistent and logical manner.

If, as the respondent maintains, deductions attributable to product liability are to be computed on a separate company basis, there would be nothing to compare them with because no separate company in an affiliated group can have its own net operating loss.

B. Consistency Requires That All Provisions Of Section 172 Be Applied On A Single Entity Basis.

Petitioner's position is perfectly in harmony with the position of the IRS, as discussed in a 1987 private letter ruling (Priv. Ltr. Rul. 8816002, December 31, 1987),[10] which considered net operating losses in the consolidated return context. The IRS made clear that the separate loss of any member of a consolidated group was not a net operating loss:

> The underlying concept behind the sections of the consolidated return regulations which deal with the CNOL [consolidated net operating loss] deduction is the application of the *single entity approach*. For example, net operating losses of members of an affiliated group are used to offset income generated by other members of the group in determining the consolidated taxable income of the group for the taxable year under sections 1.1502-11 and 12 of the regulations. Consolidated taxable income is determined, in part, by taking into account the separate taxable income (loss) of each member of the group. The computation

10. Although technical advice memoranda and private letter rulings are not official precedent, courts have found such materials useful in determining the scope of a particular regulation, as well as the manner in which the IRS has applied the regulation in other cases. *Xerox Corp. v. United States*, 656 F.2d 659, 660, n.3 (Ct. Cl. 1981).

> of the separate taxable income (loss) of each member is made without taking into account any net operating loss carryovers or carrybacks. Section 1.1502-12(h). As each member's separate net income (loss) is combined, current losses of members offset current income of other members. *Thus net operating losses are aggregated as a "group" item. An individual member may not independently carryover or carryback a net operating loss to itself to a year in which it has income. . . . Because the single entity approach is the underlying basis for the application of the net operating loss deduction in the context of the consolidated return regulations, section 172 of the Code, which provides the statutory authority for taking a net operating loss deduction, should be similarly construed as it relates to the consolidated return regulations.* [Emphasis added.]

Private Letter Ruling 8816002 is not an isolated statement of the IRS position with respect to entity characterization. In a Notice of Proposed Rulemaking related to the use of certain losses, deductions and credits under the consolidated return regulations (published in the Federal Register on February 4, 1991, 56 Fed. Reg. 4,228), the IRS asserted unequivocally (in a discussion of an approach to separate return limitation year losses known as fragmentation) that:

> Fragmentation is in many ways inconsistent with the single entity approach to the use of losses under the consolidated return regulations. The single entity approach reduces the tax

> distinctions between separate affiliated corporations and separate divisions within a single corporation, and reflects two principles. *First, corporations that file a consolidated return should be able to use each other's losses as if they were divisions of a single corporation rather than separate corporations.* Second, the tax laws should be neutral with respect to changes in ownership so that losses arising among members of a group are able to be used among the members following an ownership change, subject only to the restrictions imposed on a single entity in similar circumstances.

1991-1 C.B. 757, 759 (emphasis added). Clearly, the IRS has endorsed the single entity approach with respect to the use of losses generated by an affiliated group.

C. Congressional Intent Mandates A Liberal Interpretation Of The Product Liability Rules.

Following enactment of the Revenue Act of 1978 (P.L. 95-600), which introduced into the Code the carryback rules for product liability losses, the Staff of the Joint Committee on Taxation issued its General Explanation of the Revenue Act of 1978, 95th Cong. (Comm. Print 1979), in which it stated:

> The Congress believed that an extended carryback period should be available to taxpayers who suffer product liability losses because such losses may tend to be large and sporadic. It was believed that the extended carryback period would reduce the likelihood that a large product liability

> claim would give rise to a net operating loss in excess of taxable income during the carryback period. Furthermore, the extended carryback period makes it more likely that businesses which suffer product liability losses will obtain a current economic benefit from a tax refund rather than have to speculate on possible future tax reductions due to carryovers of operating losses. (at p. 232.)

Without question, Congress intended the change in section 172, as it related to taxpayers with product liability losses, to benefit taxpayers by accelerating the time when they could recover taxes attributable to product liability losses. The respondent's restrictive reading of section 172 in the consolidated return context completely thwarts Congressional intent.

Significantly, under the respondent's theory in this case, if a member of an affiliated group incurred expenses attributable to product liability during a consolidated return year but did not have negative separate taxable income in the same year, the group would not be able to carry back any deductions attributable to product liability of that member even though the affiliated group, as a whole, had both a consolidated net operating loss and deductions attributable to product liability.

This theory ascribes overwhelming tax significance to the organizational structure of the taxpayer's business, a result that is completely at odds with the underpinnings of the consolidated tax return regime. If it makes a tax difference to a family of commonly owned corporations whether a particular business is put into one corporation rather than another, the benefit to be gained by allowing that family of companies to file a single tax return is lost.

To illustrate, consider two different affiliated groups, *A* and *B*. Both group *A* and group *B* have a number of separate businesses, one of which is occasionally subject to very large product liability losses. For non-tax, business reasons, it is advantageous for *A* to operate this business as part of a corporation that also happens to operate a separate, highly profitable business. Group *B*, by contrast, has devoted more resources than *A* to tax avoidance planning and, in order to be well situated should the respondent's theory in this case become law, has chosen to operate the product liability business in another corporation that, when looked at on a separate company basis, almost always generates a loss. Thus, in a year in which the *A* and *B* groups generate identical consolidated net operating losses, even if their two product liability businesses result in identical product liability deductions for the year, group *B* will be able to take advantage of the special ten year carryback, whereas group *A* will not. Thus, the respondent's theory of the law results in a world where affiliated groups that enter into tax-motivated organizational structures will prevail over their more straightforward, business-motivated competitors. As a policy matter, given a choice, a sound tax system should not elevate tax planning over common sense, and the respondent's theory of the case, which would do just that, therefore should be rejected.

D. The Opinion Of The Sixth Circuit In The *Intermet* Case Correctly Analyzes The Issue In This Case.

In the *Intermet* case, the Sixth Circuit essentially adopted the petitioner's position, as presented in Sections A and B of petitioner's Argument. (Pet. App. E at 69a-72a.) The Sixth Circuit, in addition, referred to Treas. Reg. § 1.1502-80, which states, "The Code, or other law, shall be applicable to

the group to the extent the regulations do not exclude its application," and concluded that there was nothing in this regulation that was inconsistent with its opinion because section 172(b)(1)(I) applied to a "taxpayer" and, in the world of consolidated tax returns, the taxpayer was properly regarded as the affiliated group. (Pet. App. E at 74a.)

In its Brief in response to petitioner's Petition for a Writ of Certiorari in this case, respondent first asserted (p. 14) that the Sixth Circuit in *Intermet* relied on Treas. Reg. § 1.1502-80 to resolve the issue in that case. Respondent went on to state, as a second proposition, that the Sixth Circuit "erred in its construction of this regulation" which provides "that every separate corporation [joining in the filing of a consolidated tax return] is to be treated as a separate taxable entity (unless the consolidated return regulations otherwise provide)," the implication clearly being that the regulation somehow requires computing an affiliated group's product liability loss on a separate company basis.

Respondent is mistaken on both counts. First, the Sixth Circuit did not rely on Treas. Reg. § 1.1502-80 to resolve the issue before it. That Court reasoned that the arguments made by the taxpayer in that case, which are the same as those made by petitioner in Sections A and B above, were valid (Pet. App. E at 64a-70a), and then went on to point out that those arguments were not inconsistent with, or trumped by, Treas. Reg. § 1.1502-80 (Pet. App. E at 74a).

Second, the cited regulation does not have the implication urged by respondent, and the cases cited by respondent in its aforementioned brief (pp. 14-15) do not support that implication. *Moline Properties v. Commissioner,* 319 U.S. 436 (1943), and *In re Chrome Plate, Inc.,* 614 F.2d

990 (5th Cir. 1980), have nothing to do with consolidated income tax returns. Both cases deal with the general rule against disregarding a corporate entity in totally different contexts.

While the two cited Tax Court cases, *Gottesman & Co. v. Commissioner*, 77 T.C. 1149, 1156 (1981), and *H Enterprises International, Inc. v. Commissioner*, 105 T.C. 71, 85 (1995), both suggest that corporations filing consolidated returns are to be treated as separate entities to the extent that the consolidated return regulations do not require otherwise, this is not tantamount to saying that product liability losses must be determined on a separate company basis because the consolidated return regulations do not contain specific words requiring that such losses be computed on a consolidated basis.

The reality is that the structure of the consolidated return regulations does require that product liability losses be computed on a consolidated or single entity basis for the reasons set forth in Section A. Inasmuch as that structure does not provide a method for making the product liability loss computation on a separate company basis, apart from the Fourth Circuit's erroneous application of a regulation that was designed for a situation not present in this case (see discussion below in Section F), the consolidated return regulations do mandate that product liability losses be computed on a consolidated basis, as the Sixth Circuit correctly concluded in *Intermet*.

The Sixth Circuit correctly pointed out that section 172(b)(1)(I) of the Code applies to "a taxpayer" and, in the consolidated return context, most particularly with respect to net operating losses, the affiliated group is properly

regarded as the taxpayer. (Pet. App. E at 74a.) A general reading of the consolidated return regulations makes clear that this is, in fact, the case. For example:

1. An affiliated group of corporations files a single federal income tax return each year. Treas. Reg. § 1.1502-75(h).

2. All members of the affiliated group must have the same taxable year. Treas. Reg. § 1.1502-76(a)(1).

3. The affiliated group's tax liability for any year is computed on a consolidated basis after the income of profitable members of the group has been offset by losses of the unprofitable members. Treas. Reg. § 1.1502-2.

4. Section 38 of the Internal Revenue Code of 1986 currently provides a business credit, which section 38(c) limits to the excess of "the *taxpayer's* net income tax over the greater of — (A) the tentative minimum tax for the taxable year, or (B) 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000." I.R.C. § 38(c)(1) (emphasis added). Although never brought up to date, the parallel provision of the current consolidated return regulations requires an affiliated group to make this computation on a consolidated basis. Treas. Reg. § 1.1502-3(a)(3)(i).

5. Section 901(a) of the Code allows each "taxpayer" to elect to claim a foreign tax credit (in lieu of a deduction for foreign taxes), but Treas. Reg. § 1.1502-4(a) provides that any election of the common parent is also binding on every other member of the group.

6. Section 6655 of the Code, which refers to "the taxpayer" several times (*see, e.g.*, sec. 6655(e)(2)(C) and (e)(4)), requires every corporation to pay estimated income tax according to certain prescribed rules applicable to that corporation's facts, but Treas. Reg. § 1.1502-5 applies the section 6655 rules to the affiliated group on a consolidated basis, not to each member of the group individually.

E. The Failure Of The Consolidated Return Regulations To Provide Specifically For The Calculation Of Product Liability Deductions On A Consolidated Basis Has No Legal Significance.

The Fourth Circuit unequivocally agreed with petitioner that no member of an affiliated group can have its own net operating loss, and it also agreed that the IRS was incorrect in comparing a group member's product liability deductions with its separate taxable income to determine whether the member could contribute to the group's product liability loss. (Pet. App. A at 18a-21a.) The Court, nonetheless, determined that petitioner's single entity theory had to be rejected because the consolidated return regulations, although providing for a single consolidated net operating loss, did not explicitly incorporate a reference to "consolidated product liability expenses." (Pet. App. A at 14a-16a.) This conclusion is based on a faulty premise.

Treas. Reg. § 1.1502-11(a) and Treas. Reg. § 1.1502-21(f) provide, respectively, that "consolidated income" and "net operating loss" "shall be determined by taking into account" certain items. These items are the "separate taxable income" of each member of the group, and then a variety of items that must be taken into consideration on a consolidated basis. In the case of both of the cited regulations, there is no

reference to the computation of product liability deductions on a consolidated basis, which both the respondent and the Fourth Circuit erroneously found fatal to petitioner's case.

The flaw in this position is that both the respondent and the Fourth Circuit have lost sight of what the regulations seek to accomplish by having certain items computed on a consolidated basis. In both the case of taxable income and net operating loss, consolidation of certain items serves the very necessary purpose of offsetting or combining particular types of income or deductions of one group member with those of other members so that the net numbers can be incorporated in a bottom line amount of income or loss on the basis deemed appropriate by the IRS. *On the other hand, whether product liability deductions are taken into consideration on a separate company basis or on a consolidated basis has no bearing whatsoever on the computation of taxable income or net operating loss.*

No one in this case is arguing about the size of the AMCA consolidated net operating loss in any year. These are agreed upon amounts. The only issue to be determined is the portion of these agreed upon amounts that can be carried back 10 years instead of the normal three. To make this determination in the manner urged by petitioner is not in the slightest inconsistent with the failure of Treas. Reg. § 1.1502-11(a) or Treas. Reg. § 1.1502-21(f) to provide for the computation of product liability deductions on a consolidated basis because to have done so would have served no rational purpose. *Accordingly, the respondent and the Fourth Circuit are simply in error when they conclude that the consideration of product liability deductions on a consolidated basis is not permitted because the consolidation of product liability deductions is not called for expressly in*

the cited regulations. To the contrary, it would have been incongruous to have included such a provision in the regulations.

This same refutation is applicable to the Fourth Circuit's reliance on the absence of a reference to product liability deductions as one of the modifications to the computation of separate taxable income under Treas. Reg. § 1.1502-12 as justification for its determination that product liability deductions must be determined on a separate company basis. This regulation provides directions for the computation of an income number. Once again, the issue in this case has nothing at all to do with the computation of income, be it separate or combined. Thus, one would never expect to find a reference to product liability deductions in Treas. Reg. § 1.1502-12.

The fundamental error made by the Court of Appeals is that it appeared to think of the issue in this case as involving the taxpayer's right to a deduction. Deductibility is not at issue here. There is no dispute as to the amount of AMCA's consolidated net operating losses. There is no dispute that these losses may be carried to other years and deducted against income of the AMCA affiliated group in other years. The only question before this Court is whether these undisputed losses can be carried back 10 years or three years, and the answer turns not on whether any member of the AMCA affiliated group can deduct product liability expenses, but only on the manner in which they are compared with AMCA's consolidated net operating loss.

F. The Fourth Circuit Erroneously Relied On A Regulation That, By Its Own Explicit Terms, Is Not Applicable In This Case.

Having rejected both the IRS method of comparing product liability deductions with separate taxable income and the petitioner's single entity theory, the Court of Appeals found itself in somewhat of a dilemma, which it attempted to resolve on two pillars; first, the Court asserted that petitioner's position resulted in a windfall tax benefit (Pet. App. A at 16a-17a) and second, the court asserted that Treas. Reg. § 1.1502-79(a) provided the appropriate method for allocating an affiliated group's consolidated net operating loss among its members for the purpose of determining whether any particular member could contribute product liability deductions to the group to be included in the computation of the group's product liability loss (Pet. App. A at 21a-23a).

The windfall conclusion is a classic "bootstrap" argument. First decide that the IRS is correct, and then conclude that the opposite result therefore would create a windfall. Of course, this position begs the question of whether the IRS is right in the first instance. If petitioner is correct that the taxpayer to which section 172(b)(1)(I) is applicable is properly the affiliated group, then there is certainly no windfall because the result that flows from that conclusion is the intended result.

The substantive effort made by the Fourth Circuit to buttress its windfall conclusion reflects a lack of understanding as to the operation of both the consolidated return regulations and section 172:

> We agree that, were the taxpayer's reasoning to prevail, the parent corporation could obtain the extended ten-year carryback for losses incurred by individual group members (that are reflected in the parent's "consolidated net operating loss"), although the losses were not the result of product liability expenses (and thus could not be "product liability loss").

(Pet. App. A at 17a.)

An affiliated group's consolidated net operating loss is made up of all of the income and deductions of every member of the group. This loss, of necessity, includes the product liability deductions of every member of the group, whether or not the member itself has positive or negative separate taxable income. In every case, the group's consolidated net operating loss is the direct result of every member's product liability deductions. For example, if an affiliated group has a consolidated net operating loss of 100 while all the members of the group have product liability deductions of 10, the 10 is reflected dollar for dollar in the 100. If the 10 were increased to 15, the net operating loss would be increased to 105; if the 10 were decreased to 5, the net operating loss correspondingly would be decreased to 95.

The fact that money is fungible and the affiliated group's consolidated net operating loss can be said to be attributable to deductions other than those related to product liability is irrelevant because the same statement can be made in the case of a single corporation filing a separate federal income tax return. For instance, a single company filing a separate income tax return might have income of 15 and deductions

of 30, attributable to 10 of interest, 10 of depreciation and 10 of product liability. This company has a net operating loss of 15, of which 10, without question, will be properly characterized as a product liability loss. The fact that one might argue that the loss of 15 is attributable in whole or in part to the 10 of interest plus the 10 of depreciation carries no weight because section 172(j)(1) unequivocally states that the product liability loss is the lesser of the taxpayer's net operating loss or its product liability deductions. The statute does not permit the IRS to limit the taxpayer's product liability loss to 5 on the theory that the company's product liability deductions properly accounted for only one-third of the 15 net operating loss after pro rating the various deductions contributing to the taxpayer's loss.

The other justification offered for the Fourth Circuit's decision is Treas. Reg. § 1.1502-79(a), concerning which it makes the following statement:

> The regulations governing consolidated returns provide a simple and direct method for determining the portion of a group member's product liability expenses that are "product liability loss." The regulations define a group member's "separate net operating loss," *see* Treas. Reg. § 1.1502-79(a)(3), which is analogous to an individual's "net operating loss" on a separate return. By comparing each member's product liability expenses to its "separate net operating loss," that member's "product liability loss" may be properly calculated. The parent's "product liability loss" is then calculated as the total of the members' "product liability loss."

(Pet. App. A at 21a.)

There are three fundamental flaws with this reasoning. First, on its face, the regulation cited by the Fourth Circuit simply does not apply. Treas. Reg. § 1.1502-79 is captioned "Separate return years." Paragraph (a) of that section is captioned *"Carryover and carryback of consolidated net operating losses to separate return years."* Treas. Reg. § 1.1502-79(a)(1), by its terms, only applies "[i]f a consolidated net operating loss can be carried . . . *to a separate return year* of a corporation . . . which was a member in the year in which such loss arose. . . ." (Emphasis added.) In the event a consolidated net operating loss can be carried to a separate return year, the portion of the loss that can be so carried is determined under Treas. Reg. § 1.1502-79(a)(3), as explicitly stated in Treas. Reg. § 1.1502-79(a)(1). Contrary to the Fourth Circuit's conclusion, Treas. Reg. § 1.1502-79(a)(3) is accorded no other purpose in the consolidated return regulations. As noted above, *no separate return years are at issue in this case* (or in the *Intermet* case). All net operating loss carrybacks in issue apply only within the single affiliated group litigating this case. Accordingly, the Fourth Circuit's application of Treas. Reg. § 1.1502-79(a) can be construed only as a new consolidated return regulation which imposes *separate return* concepts and provisions on the determination of *consolidated return* items. The Fourth Circuit cited no technical or policy support for creating this regulation and applying it in a manner that is directly at odds with its plain language.

In *Intermet*, the Sixth Circuit considered the Fourth Circuit's approach and expressly rejected it as unpersuasive. After agreeing with an IRS statement in a related 1997 Technical Advice Memorandum, that no portion of an affiliated group's consolidated net operating loss could be attributed to a member of the group with positive separate

taxable income, the Court of Appeals pointed out that the Memorandum's further conclusion that Treas. Reg. § 1.1502-79(a)(3) could be relied on as the basis for denying petitioner's single entity approach was "entirely misplaced:"

> Section 1.1502-79(a) (redesignated as Treas. Reg. § 1.1502-79A by T.D. 8677) establishes a method for allocating CNOL to an individual member if a member seeks to carry back a loss to a "separate return year," *i.e.*, a year in which the member was not part of the consolidated group. The IRS contends that this allocation method may also apply in cases such as this one that involve carrybacks to a consolidated return year, pointing out that section 1.1502-79(a)(3) does not explicitly limit its application to separate return years. Tech. Adv. Memo. 9715002.
>
> The IRS's interpretation ignores a "fundamental rule of statutory construction that statutory language is to be read in pertinent context rather than in isolation." *Oates v. Oates*, 866 F.2d 203 (6th Cir. 1989). When reading section 1.1502-79A(a) as a whole, there is no question that it applies only to the separate return scenario. . . . We note that the Fourth Circuit recently held that a consolidated taxpayer is entitled to a "product liability loss" carryback — comparable to the [specified liability loss] carryback — for that portion of an individual member's product liability expenses that does not exceed the member's "separate net operating loss" as calculated under section 1.1502-79A(a)(3). . . . *The court offered no analysis to support its*

> *conclusion* that Treas. Reg. § 1.1502-79A(a)(3) dictates a method for calculating a member's "separate net operating loss" outside of the separate return context. . . . *For the reasons outlined above, we are unpersuaded by the Fourth Circuit's approach.*

(Pet. App. E at 72a-74a) (emphasis added).

Petitioner's case provides a good example of why courts must not take it upon themselves to write their own regulations, because the second flaw in the Fourth Circuit's reasoning is that its method of apportioning the consolidated net operating loss to individual group members completely distorts the operation of section 172(b)(1)(I), and adds undue complexity to an already complex area of the law. Petitioner asserts that the 10-year carryback amount is the lesser of an affiliated group's consolidated net operating loss or the group's total product liability expenses. The IRS, by contrast, contended below that the 10-year carryback amount is the lesser of the group's consolidated net operating loss or the sum of the product liability expenses of each member of the affiliated group, to the extent that the member had negative separate taxable income. The Fourth Circuit, however, limited the 10-year carryback amount to the lesser of the affiliated group's consolidated net operating loss or the sum of the product liability expenses of each member of the affiliated group, to the extent that amount did not exceed the member's share of the group's consolidated net operating loss, allocated under Treas. Reg. § 1.1502-79(a)(3). This convoluted calculation produces arbitrary and capricious results.

Take the following illustration. A consolidated group consists of a parent corporation and three wholly-owned

subsidiaries. The parent has no income or loss. Subsidiary A has a separate taxable loss of $500, of which $100 is attributable to product liability deductions. Subsidiary B has a separate taxable loss of $10,000. Subsidiary C has separate taxable income of $10,400. Neither B nor C has any deductions attributable to product liability. Thus, the taxpayer group has a consolidated net operating loss of $100 ($10,400-$10,000-$500).

If Subsidiary A had filed a return as a separate taxpayer, it would have had a product liability loss of $100 (the lesser of what would be, in a separate return context, a $500 net operating loss, or the $100 product liability deduction), which it could carry back 10 years. Under the taxpayer's methodology, the taxpayer affiliated group would have a product liability loss of $100 (the lesser of the $100 consolidated net operating loss or the $100 product liability deduction). Even under the IRS approach, misguided as it is, the taxpayer group would have a product liability loss of $100, because the member with the $100 product liability deduction had negative separate taxable income of $500, and the affiliated group had a consolidated net operating loss of $100.

Under the Fourth Circuit's approach, however, the group would have a product liability loss of only *$4.76* (the lesser of Subsidiary A's $100 product liability deduction or, under Treas. Reg. § 1.1502-79(a)(3), the $100 group loss, multiplied by Subsidiary A's loss of $500, divided by the sum of all separate losses, $10,500). This unwarranted result occurs solely because the bulk of the group's loss happens to have been incurred by a member with no product liability deductions. No policy rationale exists for determining the ten-year carryback in this arbitrary manner.

Clearly, the method relied on by the Fourth Circuit does not produce a result that is anything like the result that would be obtained if the member of the group with the product liability deductions had filed a separate return, which the IRS has contended was its goal, and which the Fourth Circuit indicated it was attempting to achieve by stating that "a group member's 'separate net operating loss,' [defined under] Treas. Reg. § 1.1502-79(a)(3), . . . is analogous to an individual's [presumably, the Court meant "member's"] 'net operating loss' on a separate return." (Pet. App. A at 21a.) In the example given above, the group member with the product liability deductions would have a net operating loss on a separate basis of $500 whereas the Fourth Circuit has reduced this to $4.96.

What has happened here is that the Fourth Circuit has taken a regulation that makes perfectly good sense when apportioning an affiliated group's consolidated net operating loss to separate return years and used it in a situation with which it is incompatible. When apportioning an affiliated group's consolidated net operating loss to separate return years, it makes sense to apportion that loss among the members of the group based on the portion of that loss contributed by each member incurring a loss. Thus, in the example above, if Subsidiary B's share of the affiliated group's consolidated net operating loss were properly apportioned to a separate return year, it would be appropriate for its share of the loss to be $95.24 because B contributed 95.24% of the consolidated net operating loss. The portion of the group's net operating loss remaining to be used by the group would be $4.96, thus producing a total net operating loss equal to the group's $100.

When dealing with a product liability loss, however, if one applies the allocation formula favored by the Fourth Circuit, the share of the consolidated net operating loss contributed by a member of the group has no rational relationship to the amount of product liability deductions it can contribute to the group's product liability loss, as demonstrated above. At the very least, if the Court of Appeals' view were correct, one would expect to find some correlation between what a group member's product liability loss would be on a separate company basis with what it would be within the affiliated group, a correlation that will almost never exist under the Fourth Circuit's decision or, for that matter, under any method of applying the product liability loss rules to an affiliated group on a separate company basis.

For instance, one can mathematically derive the equivalent of a net operating loss for a member of an affiliated group if one is of a mind to create yet another rule, but any assertion that this will permit calculation of the product liability loss of an affiliated group in a manner consistent with the results one would obtain if the members of the group filed separate income tax returns is without foundation.

Two simple examples will demonstrate this. First, assume a two-member affiliated group with one member, A, having the mathematical equivalent of a net operating loss of 100 that includes product liability deductions of 50. The other member, B, has net income of 200 and no product liability deductions. If A had filed a separate income tax return, A would have properly claimed a product liability loss of 50 that it could carry back 10 years. Because the affiliated group of which it is a member, however, has consolidated taxable income of 100 (B's income of 200 less A's loss of 100), neither the group nor A is entitled to a product liability loss.

Assume next, an affiliated group having three members, A, B and C. A and B each have the mathematical equivalent of a net operating loss of 100, including product liability deductions of 50. C has taxable income of 175. On a separate basis, both A and B would be entitled to claim a product liability loss of 50 each. The affiliated group of which they are members, however, has a consolidated net operating loss of only 25 which establishes the maximum product liability loss to which the entire group is entitled. Thus, instead of A and B having a combined product liability loss of 100 on a separate basis, they are limited to a product liability loss of 25 on a consolidated basis.

In short, any form of separate company approach is a "heads, I win, tails you lose" solution for the IRS. When treating a member of an affiliated group on a separate company basis would result in a product liability loss that is greater than it would be on a consolidated basis, as in the case of the two examples above, the consolidated return rules require disregarding the equivalent separate return results. On the other hand, when treating a group member as if it had filed a separate return would work to increase the returns to the fisc, as it would in the present case if respondent prevails, the IRS is adamant that only separate return accounting will do.

Clearly, only the method of determining product liability losses approved by the Sixth Circuit in the *Intermet* case, the method favored by petitioner in this case, is capable of being consistently and fairly applied in a manner that does not produce arbitrary results favoring one side or the other because, in all cases, the consolidated net operating loss, the only net operating loss that exists for an affiliated group of corporations, will always set the upper limit of the group's

product liability loss while, at the same time, the consolidated approach will permit all of the product liability deductions of the group to be taken into consideration, subject to that limitation. In short, the rule urged by petitioner recognizes that, for net operating loss purposes, an affiliated group of corporations is a single taxpayer. If this were not the case, there could be no justification for allowing the income of one member of an affiliated group to be offset by the losses of others, as prescribed by the consolidated return regulations.

The third flaw in the Fourth Circuit's opinion is that the IRS has acknowledged that, "although the consolidated net operating loss is apportioned to individual members for purposes of carry backs to separate return years, *the apportioned amounts are not separate NOLs [net operating losses] of each member.*" Preamble to Prop. Treas. Reg. § 1.1502-21(g), 49 Fed. Reg. 30,528, 30,530 (1984) (emphasis added). Thus, even if by some stretch of the imagination, Treas. Reg. § 1.1502-79(a)(3) might be applicable, the number derived by application of that regulation, in the words of the IRS itself, is not a separate net operating loss of any member of the group.

Thus, as petitioner noted in Section A of this Argument, the only net operating loss an affiliated group can conceivably have is a consolidated net operating loss. Inasmuch as section 172(j)(1) directs a comparison of a taxpayer's net operating loss with its product liability deductions, consistency can be obtained only by aggregating all of the product liability deductions of every member of the affiliated group to determine whether the resulting number is greater than, or less than, any consolidated net operating loss the group may have.

CONCLUSION

For the reasons stated above, the Court is respectfully requested to reverse the decision below of the United States Court of Appeals for the Fourth Circuit and to reinstate the decision of the United States District Court for the Western District of North Carolina, Charlotte Division, which would result in the refund to petitioner of $1,618,306 of income tax, plus interest according to law.

Respectfully submitted,

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No. 00-157

In the Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

A "product liability loss" incurred by a corporation may be carried back a maximum of ten years from the loss year and used as a deduction in the carryback year. 26 U.S.C. 172(b)(1)(I) (1988); see 26 U.S.C. 172(b)(1)(C), (f). The question presented in this case is whether, under the Treasury regulations that govern the years in which this case arose, the availability of the "product liability loss" carryback for affiliated entities that file a consolidated return is to be determined by (i) aggregating the income and expenses of the consolidated entities or, instead, (ii) separately calculating the income and expenses of each entity.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-24a) is reported at 208 F.3d 452. The opinion of the district court (Pet. App. 25a-41a) is unofficially reported at 98-2 U.S. Tax Cas. (CCH) ¶ 50,527.

JURISDICTION

The judgment of the court of appeals was entered on March 24, 2000. The petition for rehearing and for rehearing en banc was denied on May 19, 2000 (Pet. App. 42a). The petition for a writ of certiorari was filed on July 28, 2000, and was granted on November 27, 2000. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

1. The applicable provisions of Section 172 of the Internal Revenue Code, 26 U.S.C. 172 (1988), and of the regulations that govern the filing of consolidated returns for the years 1983 through 1986, 26 C.F.R. 1.1502 (1986), are set forth at Pet. 1-3 and Pet. App. 43a-59a. In addition to the regulations set forth in the petition, 26 C.F.R. 1.1502-80(a) provides in relevant part:

> The Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application. Thus, for example, in a transaction to which section 381(a) applies, the acquiring corporation will succeed to the tax attributes described in section 381(c). * * *

2. 26 U.S.C. 11(a) provides:

> A tax is hereby imposed for each taxable year on the taxable income of every corporation.

3. 26 U.S.C. 1501 provides, in relevant part:

> An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. * * *

4. 26 U.S.C. 1502 provides:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

STATEMENT

1. a. The Internal Revenue Code imposes a tax each year "on the taxable income of every corporation." 26 U.S.C. 11(a). In calculating that tax during the years relevant to this suit, a corporation was allowed to carry back for a period of three years the amount of any "net operating loss" it incurred. 26 U.S.C. 172(b)(1)(A) (1988). If the corporation incurred a "product liability loss," however, the amount of that loss could be carried back a period of ten years from the loss year and used as a deduction in the carryback year. 26 U.S.C. 172(b)(1)(I) (1988).[1] The term "product liability loss" was defined for this purpose to mean the lesser of (i) the "net operating loss for such year" incurred by the corporation or (ii) the deductible expenses incurred by the corporation that were

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[1] The provisions formerly located at Section 172(b)(1)(I) have been relocated at Section 172(b)(1)(C), (f). See 26 U.S.C. 172(b)(1)(C), (f). Unless otherwise noted, the statutory references hereafter set forth in this brief are to the Internal Revenue Code as in effect between 1983 and 1986.

attributable to the satisfaction or defense of product liability claims. 26 U.S.C. 172(j)(1).

b. Petitioner is the successor in interest to the common parent of an affiliated group of corporations that filed consolidated federal income tax returns for the taxable years 1983-1986. Pet. App. 3a. By filing consolidated returns, these corporations "consent[ed] to all the consolidated return regulations prescribed under section 1502 [of the Internal Revenue Code] prior to the last day prescribed by law for the filing of such return." 26 U.S.C. 1501. That statute broadly authorizes the Secretary to adopt such consolidated return regulations as he "may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group * * * may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability * * * and in order to prevent avoidance of such tax liability." 26 U.S.C. 1502.

The affiliated corporations that joined in the consolidated returns for 1983-1986 included Jesco, Inc., Cherry-Burrell Corporation, Amtel, Inc., The Litwin Corporation and Litwin Panamerican Corporation, each of which incurred product liability expenses during these years.[2] Pet. App. 3a, 26a. Although petitioner reported consolidated net operating losses when combining *all* of its affiliated corporations for each of the years from 1983 to 1986,[3] the affiliates named above

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[2] Petitioner formed Cherry-Burrell in 1975. Petitioner acquired the other corporations at various times after 1976. Pet. App. 4a n.5.

[3] Petitioner reported consolidated net operating losses of $140,402,175 for 1983, $114,134,256 for 1984, $ 85,521,645 for 1985,

that had product liability expenses each generated positive net income during some or all of these years. *Id.* at 26a-27a.[4] The issue in this case is whether the product liability expenses incurred by the affiliates that had *positive* separate incomes during these years constitute "product liability *losses*" under 26 U.S.C. 172(b)(1)(I) (emphasis added) that may be carried back ten years and deducted from petitioner's taxable income for the years 1973-1976.

2. The Internal Revenue Service determined that the product liability expenses incurred by the affiliates that generated a positive separate net income during 1983-1986 did not give rise to product liability "losses"

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and $101,221,077 for 1986. J.A. 8. The following amounts of product liability expenses were incurred by these affiliates during the 1983-1986 taxable years (Pet. App. 27a):

Corporation	Product Liability Expenses			
	1983	1984	1985	1986
Jesco	$166,042	$1,402,931	$1,292,733	$127,682
Cherry-Burrell	34,608	192,287	8,642	87,760
Amtel	0	12,135	13,218	7,549
Litwin	5,250	0	14,139	8,909
Panamerican	19	1,987	5,056	502
Total	$205,919	$1,605,342	$1,333,788	$232,402

[4] Jesco, Cherry-Burrell and Panamerican had positive "separate taxable income" (under 26 C.F.R. 1.1502-12) for each year between 1983 and 1986. Pet. App. 27a. Amtel had positive separate taxable income for 1984, 1985 and 1986, and negative separate taxable income (of $3,017,912) only for 1983. *Ibid.* Litwin had positive separate taxable income for 1983, 1985 and 1986, and negative separate taxable income (of $399,300) only for 1984. Litwin claimed $4198 in product liability deductions during 1984, a year in which it computed negative separate taxable income. *Ibid.* As explained at note 7, *infra*, the tax consequences of Litwin's 1984 deductions are not at issue in this case.

that could be carried back ten years under Section 172. Because these affiliates each generated positive incomes—rather than "losses"—during those years, no "product liability losses" were incurred under the plain text of the statute. Pet. App. 28a.

Petitioner thereafter brought two separate refund suits to challenge the Service's determination. In the first suit, which was commenced in the United States Court of Federal Claims, petitioner asserted that the product liability expenses incurred during 1985 by the group of profitable affiliates that petitioner acquired after 1976 (see note 2, *supra*) generated a "product liability loss" that could be carried back ten years and deducted from the gross income reported on the separate returns filed by those affiliates in 1975.[5] Petitioner argued that this group of affiliates was entitled to this carryback on the theory that "a consolidated group is treated as a single entity with respect to the product liability loss provisions." *Amtel, Inc.* v. *United States*, 31 Fed. Cl. 598, 599 (1994), aff'd, 59 F.3d 181 (Fed. Cir. 1995) (Table). The Court of Federal Claims rejected petitioner's claim. The court held that petitioner's affiliates "cannot carry back a product liability loss from 1985 to 1975 because [they] had no net operating loss in 1985." 31 Fed. Cl. at 600. Relying on the consolidated return regulations adopted by the Treasury under Section 1502, the court concluded that these affiliates had no "separate net operating loss" (26 C.F.R. 1.1502-

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[5] In 1975, Amtel was the common parent of an affiliated group of corporations that included Litwin and Panamerican. Those corporations were not members of petitioner's affiliated group in that year. The consolidated return regulations accompanying Section 1502 of the Code denominate the 1975 taxable year a "separate return year" for Amtel, Litwin and Panamerican. See 26 C.F.R. 1.1502-1(e).

79(a)(3)) for 1985 to carry back to their 1975 separate return year. 31 Fed. Cl. at 601. Because, as the affiliates acknowledged, their "separate net operating loss * * * was zero," the court held that there was no product liability "loss" to be carried back. *Ibid.*

The Court of Federal Claims expressly rejected petitioner's argument that a "consolidated" product liability loss occurred merely because *other* reporting entities included on petitioner's 1985 consolidated return—entities that themselves had no product liability expenses—incurred losses that were sufficient to create an aggregate net operating loss on the consolidated return. The court explained that the governing "regulations do not use the term 'consolidated product liability loss' or incorporate such a concept by directing that product liability loss be treated on a consolidated basis." 31 Fed. Cl. at 602. The Federal Circuit affirmed the decision of the Court of Federal Claims in an unpublished opinion. 59 F.3d 181 (1995) (Table).

3. After the Federal Circuit issued its opinion in *Amtel*, petitioner filed this second refund suit in the United States District Court for the Western District of North Carolina. In this second suit, petitioner contended that the product liability deductions claimed by its affiliates during 1983, 1984, 1985 and 1986 created product liability "losses" that could be carried back ten years and deducted from *petitioner's* consolidated taxable income for 1973, 1974, 1975 and 1976.[6] The

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[6] Those years were all *before* the date on which these affiliates had become part of petitioner's consolidated group. See note 2, *supra*.

complaint sought a refund of $1,618,305 plus statutory interest. J.A. 15.[7]

The district court granted summary judgment to petitioner. Pet. App. 25a-41a. The court agreed with the argument that the Court of Federal Claims had rejected in the *Amtel* case, and concluded that an affiliated group's product liability "loss" is to be determined on a consolidated basis. *Id.* at 38a-39a.[8] The district court held that, so long as the consolidated return reflects an *aggregate* net operating loss, the product liability expenses incurred by *profitable* affiliates may be employed to generate "product liability *losses*" that may be carried back and set off against any earnings of the consolidated entities for a period of up to ten years. *Ibid* (emphasis added).

4. The court of appeals reversed. Pet. App. 1a-24a. The court concluded that the consolidated return regulations "make[] clear * * * that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated 'product liability loss' is not intended." *Id.* at 16a. The court observed that, under the consolidated return regulations, "product

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[7] The refund claim included the product liability deductions claimed by Litwin in 1984. Petitioner conceded in the court of appeals, however, that under 26 C.F.R. 1.1502-79(a)(3), Litwin's 1984 product liability loss could not be carried back to petitioner's 1974 consolidated return year because Litwin was not a member of petitioner's affiliated group in that year. See Pet. App. 4a n.4.

[8] The district court held that the decision in *Amtel* did not collaterally estop petitioner from asserting, in the context of this case, that product liability losses must be accounted for on a consolidated basis. Pet. App. 39a-40a. The United States did not challenge that collateral estoppel determination in the court of appeals, and the issue is not now presented in this case.

liability expenses are linked to the consolidated net operating loss only through their nexus to the group member" (*ibid.*) and "that an interpretation removing the close nexus between such expenses and whether the affected company operated at a loss is inconsistent with the regulations." *Id.* at 17a. The court concluded "that determining 'product liability' loss separately for each group member is correct and consistent with the regulations." *Ibid.* The court explained the proper method under the regulations for determining product liability loss on a consolidated return (*id.* at 21a):

> The regulations governing consolidated returns provide a simple and direct method for determining the portion of a group member's product liability expenses that are "product liability loss." The regulations define a group member's "separate net operating loss," *see* Treas. Reg. § 1.1502-79(a)(3), which is analogous to an individual's "net operating loss" on a separate return. By comparing each member's product liability expenses to its "separate net operating loss," that member's "product liability loss" may be properly calculated. The parent's "product liability loss" is then calculated as the total of the members' "product liability loss."

SUMMARY OF ARGUMENT

I. Because product liability expenses are often incurred by businesses in an unforeseen and unpredictable manner, Congress has provided a special tax rule for losses resulting from such expenses. When a taxpayer incurs product liability expenses, it must first deduct them in the year they are incurred as "ordinary and necessary" business expenses under Section 162 of the Internal Revenue Code. If any portion of such

product liability expenses is *not* effectively employed as deductions in that year—because there is insufficient taxable income that year to set them against—then that unconsumed portion of those expenses (and only that portion) constitutes a "product liability loss" that, under Section 172 of the Code, may be carried back as many as ten years and be set off against previously earned taxable income.

In the present case, it is undisputed that each of the affiliated corporations that incurred product liability expenses in the tax years at issue would have reported positive net income—rather than a net operating loss—for those years if it had filed a separate return that reflected its individual operations. Under the plain text of the statute, none of these entities would have been entitled to a "product liability loss" deduction on a separate return, for none of them incurred a "loss." Instead, each of these profitable entities obtained a full and effective current use of its product liability expenses by deducting them in the year the expenses were incurred.

II. Petitioner concedes that its affiliates with product liability expenses had positive separate incomes and therefore would not qualify for a "product liability loss" carryback as individual corporations. Petitioner nonetheless asserts that the fact that these profitable affiliates filed a consolidated return with *other* entities —entities that had operating losses but *no* product liability expenses—somehow requires a different result. That contention is incorrect because, under the governing consolidated return regulations, the product liability expenses of each affiliate must be netted against the income of that affiliate in determining the "separate taxable income" of that member of the group. When, as in this case, the "separate taxable income" of the affiliates with product liability is *positive*, then all of the

product liability expenses have been fully utilized in reducing taxable income at that level. As a consequence, there are no unconsumed or unutilized product liability expenses—or "product liability losses"—to carry to the consolidated level of the group.

By contrast, under these controlling regulations, if an individual affiliate has a negative separate income for the current year *and* unconsumed product liability expense deductions for that year, those unutilized product liability expenses are properly carried to the consolidated level. They are then first applied to offset any net operating profit from other affiliates at the consolidated level—thereby providing an immediate tax benefit from the deductions. If, after application of such deductions, the consolidated entity realizes a positive net operating income, then all of the product liability expenses have (by definition) been consumed as deductions in that year and there is nothing left to carry to other years. Alternatively, if a consolidated net operating *loss* results in the current year, then any product liability expenses that have not either been utilized by the individual entity that incurred them or been consumed at the consolidated level may be carried back for as many as ten years as "product liability losses" for the consolidated entity. On the facts of this case, however, *all* of the product liability expenses were fully deducted in determining the separate income of the profitable individual affiliates that incurred those expenses. There are thus no unutilized deductions, or "product liability losses," in this case.

Petitioner is incorrect in asserting that, as applied to a consolidated group of corporations, the "taxpayer" to whom the "product liability loss" provisions apply is exclusively the consolidated group. Even though separate affiliated taxpayers may join in filing a

consolidated return, "each of [the] corporations joining * * * in a consolidated return is none the less a taxpayer." *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 328 (1932). The text and history of Section 172(j) both make clear that the "taxpayer" referred to in that statute is the corporation that has *itself* incurred product liability expenses and is unable fully to utilize them due to an insufficient amount of current income. Congress was concerned with smoothing the accounting of the income and expenses of the individual entity that is liable for product liability expenses. The statute is not designed to provide tax benefits for affiliated entities that (either by conscious corporate design or by historical accident) have kept themselves and their assets free from any liability for these expenses.

Moreover, Congress did not intend to provide any tax benefit to a *profitable* corporation—such as the affiliates involved in this case—even though that corporation might have had large product liability expenses. When, as here, a profitable corporation employs its product liability expense deductions to reduce its net income in the current period, there are no remaining unused deductions—or "product liability losses"—for it to pass to its affiliates on a consolidated return either as current deductions or as a carryback to prior years under Section 172(j).

The rule that petitioner advocates would permit significant tax avoidance abuses. Under petitioner's approach, a corporation that is currently unprofitable but that had substantial income in prior years could (i) acquire a profitable corporation with product liability expense deductions in the year of acquisition, (ii) file a consolidated return and (iii) thereby create an otherwise nonexistent "product liability loss" for the new affiliated group that would allow the acquiring corpora-

tion to claim refunds of the tax it paid in prior years. As this Court emphasized in a case that involved a similar abuse, "[t]he mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious." *Woolford Realty Co.* v. *Rose*, 286 U.S. at 330. The result advocated by petitioner thus would not only contravene the text and intent of the governing statute and regulations, it would also defeat the directive of Congress that consolidated returns not be employed as an artifice for "avoidance of such tax liability." 26 U.S.C. 1502.

ARGUMENT

Whether reported on a separate or consolidated return, product liability expenses are to be deducted by each individual corporation in determining the net income attributable to that individual entity. When, as in this case, the resulting net income of each individual corporation with product liability expenses is positive, there are no unused product liability deductions—or "product liability losses"—to be carried back and deducted from income in prior years under section 172 of the Internal Revenue Code.

I. NONE OF THE INDIVIDUAL CORPORATIONS INVOLVED IN THIS CASE INCURRED A PRODUCT LIABILITY LOSS WITHIN THE MEANING OF SECTION 172 OF THE INTERNAL REVENUE CODE.

A. The Internal Revenue Code imposes a tax each year "on the taxable income of every corporation." 26 U.S.C. 11(a). In calculating that taxable income, a corporation was allowed by Section 172 of the Code to carry back for a period of three years, or carry forward for a period of 15 years, the amount of any "net

operating loss" it incurs. 26 U.S.C. 172(b)(1)(A), (B).[9] Section 172(c) generally defines a "net operating loss" as "the excess of the deductions allowed by this chapter over the gross income." 26 U.S.C. 172(c). Thus, "[a] taxpayer does not have a [net operating] loss for a particular year unless its deductions exceed its ordinary income and its capital gains." *United States* v. *Foster Lumber Co.*, 429 U.S. 32, 47 (1976). By providing for the carryforward and carryback of net operating losses, Section 172 "permit[s] a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year." *Lisbon Shops, Inc.* v. *Koehler*, 353 U.S. 382, 386 (1957).

Although the general carryback period for a net operating loss is three years from the year in which the loss is incurred, Congress adopted a special ten-year carryback period for a "product liability loss" incurred by a "taxpayer." 26 U.S.C. 172(b)(1)(I).[10] The term "product liability loss" is defined to mean, for any taxable year, "the lesser of" the "net operating loss for

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[9] Unless otherwise noted, the statutory references in this brief are to the Internal Revenue Code and Treasury regulations as in effect between 1983 and 1986. See note 1, *supra*. In the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1082(a)(1)-(2), 111 Stat. 950, Congress amended Section 172(b)(1)(A) to shorten the general carryback period to two years and to enlarge the carryforward period from fifteen years to twenty years.

[10] The product liability loss is carried back a maximum of ten years to the earliest taxable year for which the taxpayer reported taxable income. 26 U.S.C. 172(b)(2). In the event any portion of the loss remains after application in the earliest taxable year, the remainder is carried forward to the next taxable year for which the taxpayer reported taxable income. *Ibid.* The process continues until the loss is used up.

such year" or the deductible expenses incurred by that entity that are "attributable to" the satisfaction or defense of product liability claims. 26 U.S.C. 172(j)(1).[11] A "taxpayer" thus has a "product liability loss" for a particular taxable year only if (i) the taxpayer has a net operating loss for the year (*i.e.*, its total deductions exceed its gross income) *and* (ii) that net operating loss is attributable in whole or in part to deductions for product liability or product liability expenses.

In adopting this provision, Congress was concerned that product liability expenses are often incurred in cycles that are not clearly reflected under normal tax accounting principles. Although income is earned upon the sale of a product, associated liability expenses may not be incurred for many years thereafter. And, when such liability expenses are incurred, they are often "large and sporadic." Staff of Joint Comm. on Taxation, 96th Cong., 1st Sess., *General Explanation of the Revenue Act of 1978 (H.R. 3511, 95th Cong., Pub. L. 95-600)* 232 (1979). The extended carryback period for product liability losses under Section 172 is designed to "allow businesses to use previous taxable income as at least a partial reserve" against product liability expenses subsequently incurred by that company. 124 Cong. Rec. 34,733 (1978) (Sen. Culver).

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[11] The term "product liability" is defined as (26 U.S.C. 172(j)(2)):

> liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

To accomplish this goal, Congress established the following method for accounting for product liability expenses. When a taxpayer incurs product liability expenses, it must first deduct them in the year they are incurred as "ordinary and necessary" business expenses under Section 162 of the Code. 26 U.S.C. 162. If any portion of such product liability expenses is *not* effectively employed as deductions in that year—because there is insufficient taxable income that year to set them against—then that *unconsumed* portion of those expenses (and only that portion) constitutes a "product liability loss" that may be carried back as much as ten years and be set off against previously earned taxable income.

Section 172 is plainly not designed to provide the taxpayer with a *double* deduction. The extended carryback of losses permitted under that Section allows a corporation that incurs product liability expenses only *one* effective use of a deduction for these expenses—by permitting the deduction to be carried back to a prior year when, due to an insufficient amount of income from current operations, the corporation is not able fully to utilize the expense as a deduction in the current year.

If all of the product liability expenses are consumed in determining the taxable income of the liable corporation, and the corporation thus has no net operating loss, it cannot have a "product liability loss" under this statute. 26 U.S.C. 172(j)(1). And, if the corporation *does* have a net operating loss, the amount of its "product liability loss" is defined as the *lesser* of the amount of that loss or the amount of the product liability expenses incurred in that year by the corporation—in other words, it is the portion of the product liability expenses that are not *effectively utilized* as deductions

to reduce the taxable income of the corporation in the current year. See *ibid.*

B. The various possible applications of the "product liability loss" provisions to individual corporations are all encompassed within the following three examples.

1. If the corporation has product liability expenses for a particular tax year but has sufficient income that it does not incur a net operating loss for that year, it has no "product liability loss," for Section 172(j)(1) defines that term as the *lesser* of the net operating loss for the taxable year or the amount of product liability deductions claimed by the taxpayer during that year. 26 U.S.C. 172(j)(1). Since the product liability expenses were fully and effectively utilized in that year as current deductions under Section 162, there are no unconsumed product liability expenses—or "product liability losses"—to carry back to other years.

2. If the corporation incurs a net operating loss for the taxable year but has no product liability expense deductions during that year, there are necessarily no unconsumed product liability deductions in that year and thus no "product liability losses" to carry back to other years under 26 U.S.C. 172(j)(1). The corporation does, however, have a "net operating loss" for the year that may be carried back a maximum of three years under 26 U.S.C. 172(b)(1)(A).

3. If the corporation incurs a net operating loss for the taxable year and has product liability expenses in that year, two situations may arise. First, if the product liability expenses incurred in that year are *less* than the net operating loss for that year, the corporation has a "product liability loss" (with a ten-year carryback) only for the amount of the product liability expenses; the remaining portion of the net operating loss may be carried back only for the three-year period

allowed by Section 172(b)(1)(A). Second, if the product liability expenses are *greater* than the amount of the net operating loss, only the unconsumed portion of the product liability expenses—which is then equal to the amount of the net operating loss—constitutes a "product liability loss" for which a ten-year carryback is permitted. 26 U.S.C. 172(j)(1).

C. In the present case, it is undisputed that each of the affiliated corporations that incurred product liability expenses in the tax years at issue would have reported *positive* net income—rather than a net operating loss—for those years if it had filed a separate return that reflected its individual operations. Pet. App. 27a; see page 7, *supra*. Under the plain text of Section 172, none of these entities would have been entitled to a "product liability loss" deduction on a separate return, for none of them incurred a "loss." 26 U.S.C. 172(j)(1). Instead, each of these entities obtained a full and effective use of its product liability expenses by deducting them in the year the expenses were incurred.

Because these expenses were fully utilized as deductions in the year they were incurred, there were no unconsumed product liability expenses—or "product liability losses"—for these corporations to carry back to set off against their taxable income in prior years. See *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601. Indeed, petitioner concedes that none of these entities had a negative taxable income "when considered on a separate company basis" (Pet. Br. 7 (emphasis omitted)). It therefore follows that none of these corporations would be able to claim a "product liability loss" under Section 172 if it had filed a separate return. See also *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601.

II. WHEN PROFITABLE CORPORATIONS WITH PRODUCT LIABILITY EXPENSES FILE A CONSOLIDATED RETURN WITH AFFILIATES THAT GENERATE LOSSES BUT HAVE NO PRODUCT LIABILITY EXPENSES, THE RESULTING CONSOLIDATED NET OPERATING LOSS IS NOT A "PRODUCT LIABILITY LOSS" UNDER SECTION 172(j) OF THE CODE

While conceding that its affiliates with product liability expenses had positive separate incomes and therefore would not qualify for a "product liability loss" carryback as individual corporations, petitioner nonetheless asserts that the fact that these profitable corporations joined in filing a consolidated tax return with *other* entities—entities that had operating losses but *no* product liability expenses—somehow requires a different result.[12] The court of appeals correctly held, however, that petitioner may not use product liability expenses incurred by a profitable affiliate to generate "product liability losses" to be carried back ten years on petitioner's consolidated return. Under Section 172 and the consolidated return regulations, product liability losses must be calculated "separately for each group member." Pet. App. 17a.

A. *The Consolidated Return Regulations Require The Accounting For Product Liability Expenses To Occur First At The Separate Entity Level*

1. The Internal Revenue Code vests ample authority in the Treasury to adopt consolidated return regulations to effect a binding resolution of the question

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[12] The losses incurred by these other entities would represent "net operating losses" for which a three-year carryback would be permitted if they had filed separately. 26 U.S.C. 172(b)(1)(A).

presented in this case. Section 1501 of the Code specifies that affiliated corporations may file a consolidated income tax return, "in lieu of separate returns," only "upon the condition that * * * the affiliated group consent to all the consolidated return regulations prescribed under Section 1502 prior to the last day prescribed by law for the filing of such return." 26 U.S.C. 1501.[13] In turn, Section 1502 authorizes the Secretary of the Treasury to:

> prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

26 U.S.C. 1502. Any taxpayer that files a consolidated return is bound by the regulations that are in effect on the date the return was due (26 U.S.C. 1501), and the tax on the consolidated return is to "be determined, computed, assessed, collected, and adjusted in accordance with the[se] regulations * * * ." 26 U.S.C. 1503(a).

2. a. The consolidated return regulations promulgated by the Secretary under Section 1502 arrive at a single figure of "consolidated taxable income" for the

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[13] The Internal Revenue Code generally defines an "affiliated group" as "1 or more chains of includible corporations connected through stock ownership with a common parent corporation." 26 U.S.C. 1504(a)(1)(A).

affiliated group by starting first at the individual entity level. 26 C.F.R. 1.1502-11(a). Section 12 of the regulations provides that, subject only to the specific modifications set forth in the regulation, "*[t]he separate taxable income of a member * * * is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations * * *.*" 26 C.F.R. 1.1502-12 (emphasis added). Product liability expenses are *not* included among the specific items for which modified treatment is provided in computing the "separate taxable income of a member" under this regulation. See *ibid.*; pages 22-23, *infra*. As a result, the product liability expenses of each affiliate must be netted against the income of that affiliate in determining the "separate taxable income" of that member of the group. When, as in this case, the "separate taxable income" of the affiliates with product liability expenses is *positive*, then all of the product liability expenses have necessarily been consumed and utilized in reducing taxable income at that level. As a consequence, there are no unconsumed or unutilized "product liability losses" to carry to the consolidated level of the group. It is only when the separate taxable income of the individual member is *negative* that there will be an unutilized product liability loss to carry to the consolidated level.[14]

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[14] "The term 'separate taxable income' * * * include[s] a case in which the determination * * * results in an excess of deductions over gross income." 26 C.F.R. 1.1502-12(q). As we discuss in further detail below (pages 24-27, *infra*), the "separate taxable income" computed by a member of an affiliated group is not necessarily equivalent to the income or net operating loss figure that the corporation would have computed if it had filed a separate return. It is possible for a corporation to compute positive separate taxable income even though the corporation would

b. Under the regulations, the following items are excluded from the computation of the "separate taxable income" of each member and are instead treated as "consolidated items" that flow through directly to the "consolidated taxable income" of the affiliated group: (1) the consolidated net operating loss deduction (computed under 26 C.F.R. 1.1502-21); (2) any consolidated capital gain net income; (3) any consolidated Section 1231 net loss; (4) any consolidated charitable contributions deduction; (5) any consolidated Section 922 deduction; (6) any consolidated dividends received deduction; and (7) any consolidated Section 247 deduction. 26 C.F.R. 1.1502-12 (a)-(n). The net operating profit or loss of the consolidated entity is determined by

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have reported a net operating loss if it had filed a separate return. For example, if a corporation made a charitable contribution during a particular year, it conceivably could have had a "net operating loss" under Section 172 even though it computed positive separate taxable income under the consolidated return regulations, because the charitable contribution deduction is not taken into account in the computation of separate taxable income. See 26 C.F.R. 1.1502-12(*l*). Conversely, it is possible for a corporation to compute negative separate taxable income even though it would have reported positive income if it had filed a separate return. That would occur if the corporation had capital gains that, along with the other income it earned, exceeded the corporation's deductions, since capital gains are not taken into account in the computation of separate taxable income. See 26 C.F.R. 1.1502-12(j). The record of this case, however, reflects that no member of petitioner's affiliated group that computed positive separate taxable income and claimed product liability deductions would have had a "net operating loss" under Section 172 if it had filed a separate return. Petitioner has acknowledged that its profitable affiliates had positive separate taxable income and incurred no separate net operating losses in the years relevant to this case. Pet. Br. 7; *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601.

adding these "consolidated items" to the aggregated amount of "separate taxable income" calculated for each of the individual affiliates. 26 C.F.R. 1.1502-11. See also 26 C.F.R. 1.1502-21(f) ("[t]he consolidated net operating loss shall be determined by taking into account * * * [t]he separate taxable income of each member of the group").[15]

Under these provisions, if an individual affiliate had a separate operating loss for the current year (a negative "separate taxable income") and had unconsumed product liability expenses for that year, the unutilized

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[15] The consolidated net operating loss deduction, for which a three-year carryback is permitted under Section 172(b), is defined in the regulations as "an amount equal to the aggregate of the consolidated net operating loss carryovers and carrybacks to the taxable year," which consists "of any consolidated net operating losses (as determined under paragraph (f) of this section) of the group, plus any net operating losses sustained by members of the group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b)." 26 C.F.R. 1.1502-21(a),(b). Paragraph (f) of the regulation, in turn, provides that the "consolidated net operating loss" of the group is determined by aggregating "[t]he separate taxable income * * * of each member of the group" along with the consolidated items (such as capital gains and charitable deductions) that are dealt with directly at the consolidated, rather than the individual corporate, level. 26 C.F.R. 1.1502-21(f); see page 21, *supra*.

The "consolidated net operating loss" of an affiliated group of corporations is thus determined in the same manner as the group's consolidated taxable income. Each member of the group computes its separate taxable income or loss, the separate taxable income or loss figures are aggregated into a single figure, and this figure is adjusted by taking into account the consolidated items set forth in the regulation. The resulting consolidated net operating loss may then be carried back (or forward) to other taxable years for which the group reported taxable income and be deducted as part of the group's consolidated net operating loss deduction for those years.

product liability expenses would then be applied to offset any net operating profit from *other* affiliates at the consolidated level—thereby providing an immediate tax benefit from the deduction. If, after application of such deductions, the consolidated entity realizes a net operating profit, then all of the product liability expenses have (by definition) been consumed as deductions in that year and there is nothing left to carry to other years. If, however, the consolidated entity realizes a net operating loss in the current year, then any product liability expenses that had not (i) first been utilized by the individual entity that incurred them, or (ii) thereafter been consumed at the consolidated level may then be carried back for as many as ten years as "product liability losses" for the consolidated entity.

c. Even in this situation, however, the carryback will not be allowed if the corporations have not been members of the same affiliated group throughout the carryback period. See *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601; pages 6-7, *infra*. In providing for consolidated returns, Congress directed the Treasury to adopt regulations to ensure that such returns are not employed as an artifice for "avoidance" of taxes or to distort the clear reflection of income. 26 U.S.C. 1502. Acting under this directive, the Treasury has promulgated detailed rules that limit the ability of affiliated corporations to carry consolidated losses back to their separate return years. 26 C.F.R. 1.1502-79A. By limiting the carryback of losses to separate return years, these rules forestall the trading in tax losses that could occur through the acquisition of profitable corporations by corporations with losses, or vice versa. As this Court stated in *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 329 (1932), rules of this type are required to

avoid "the mischiefs certainly to be engendered" by permitting such abuse to occur. Without such restrictions on the use of loss carrybacks on consolidated returns, "a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes." *Id.* at 329-330. As the Court emphasized in *Woolford Realty*, "[t]he mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious." *Id.* at 330.

Under the anti-abuse regulations adopted by the Treasury, a corporation may carry back to its "separate return years" only the portion of the consolidated loss that is attributable to its own operations. 26 C.F.R. 1.1502-79A(a)(1). That amount is determined in a two-step process. First, the entity's "separate net operating loss" is determined by adding to that entity's "separate taxable income" its share of the consolidated items that are treated directly on the consolidated return under the regulations described above. 26 C.F.R. 1.1502-79A(a)(3); see 26 C.F.R. 1.1502-12. Second, a ratio is applied to the amount of the entity's "separate net operating loss" to allocate to that entity the portion of the entire consolidated loss that is attributed to the separate operations of the individual entity. 26 C.F.R. 1.1502-79A(a)(3).[16]

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[16] That ratio may be expressed as a fraction, the numerator of which is the consolidated loss of the entire group and the denominator of which is the sum of the "separate net operating losses" of the entities that had such losses. 26 C.F.R. 1.1502-79A(a)(3). Because the separate net operating losses of the affiliates that have losses may be used to offset positive income of other affiliates, this fraction will never be greater than one but will often be less than one.

In rejecting the contention advanced by petitioner that "there is no such thing as a separate net operating loss for any separate member of an affiliated group" (Pet. Br. 10-11), the court of appeals correctly pointed out that this anti-abuse regulation utilizes the exact concept of a "separate net operating loss" (26 C.F.R. 1.1502-79A(a)(3)) in directing application of the net operating loss carryback provisions in the consolidated return context. Pet. App. 21a. We agree with the court of appeals that the regulatory definition of the term "separate net operating loss" "is analogous to an individual's 'net operating loss' on a separate return." *Ibid.* We also agree that, if a situation arose in which a taxpayer had items that were excluded in the calculation of "separate taxable income" under 26 C.F.R. 1.1502-12(a), then application of the regulatory concept of "separate net operating loss" from the anti-abuse provisions of 26 C.F.R. 1.1502-79A(a)(3) by analogy would not be inappropriate.[17] But neither this case, nor

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Contrary to the suggestion of petitioner (Pet. Br. 35-36), however, the government has not advocated that this allocation formula, which was specifically developed in the anti-abuse regulation to address the special problem of separate return years (see *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601), would apply outside that context. The court of appeals also did not apply that ratio in this case. Instead, it denied petitioner's claim expressly because the profitable affiliates in this case had no "separate net operating loss," and thus no unutilized "product liability losses" to carry to the consolidated level of petitioner's return. Pet. App. 21a-23a.

[17] The rationale applied by the court of appeals in this case appears to be a sensible way to harmonize the product liability loss provisions of Section 172 of the Code with the consolidated return regulations. The "separate net operating loss" described in 26 C.F.R. 1.1502-79(a)(3) adds the excluded consolidated items (under 26 C.F.R. 1.1502-12(a)) back to the separate taxable income of the

any other pending case of which we are aware, presents such a factual scenario.[18] See note 14, *supra*.

It is sufficient to resolve the present case to note that under both (i) the direct text of the regulations that were in fact in place in the relevant years (26 C.F.R. 1.1502-21(f)) and (ii) the analogous principles set forth in the anti-abuse rule for application of consolidated losses to separate entities (26 C.F.R. 1.1502-79A(a)(3)), product liability expenses must *first* be applied in determining the separate income of the affiliate to which the product liability has attached. Only the portion of that amount that remains *after* applying those expenses against the current income of that affiliate then passes to the consolidated entity, where it is then set off against items of current income of *other* affiliates before any then-remaining amount is eligible for carryback to prior years. Because, as petitioner concedes, none of the affiliates involved in this case that had product liability expenses had either a negative "separate taxable income" or a "separate net operating loss" (see notes 14, 18, *supra*), it is a mathematical fact that none of those affiliates had any unutilized product

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affiliate and is thus analogous to the "net operating loss" that would be computed if that entity filed a separate return. Because those two measures of separate income yield identical results in this case, however, whether the anti-abuse provisions should apply here should be left for resolution by the Treasury in prospectively applicable regulations adopted under the broad authority provided by Section 1502. See pages 28-29, *infra*.

[18] This issue could arise only if there were "consolidated items" derived from a particular affiliate—an affiliate with product liability expenses in that period—that were sufficient to alter a *positive* "separate taxable income" for that affiliate into a "separate net operating *loss*." This unusual factual combination has not been presented in any pending case.

liability loss deductions to carry to the consolidated return. Because these entities had no unused deductions, there were no "product liability losses" to account for at the consolidated level. The entire amount of the consolidated net operating loss is thus subject only to the three-year carryback authorized by Section 172(b), rather than the ten-year carryback provided for "product liability losses" under Section 172(j).

d. Congress has directed the Secretary of the Treasury—rather than the courts—to devise rules to ensure that consolidated returns achieve a full and clear reflection of income. 26 U.S.C. 1502. See *United States* v. *Correll*, 389 U.S. 299, 307 (1967).[19] It is evident from inspection of the complexities of the anti-abuse rules established in 26 C.F.R. 1.1502-79A that the Secretary will be required to give careful attention to ensuring that any detailed rule in this area guards against the "opportunity for juggling" that consolidated returns can provide in this and related contexts. *Woolford Realty Co.* v. *Rose*, 286 U.S. at 330. It is therefore appropriate to defer to the future the question whether the "separate net operating loss" definition contained in the anti-abuse regulations should apply, by analogy, to a case in which the facts could possibly call for application of such a rule. See note 18, *supra*. Since that issue is not presented on the facts of this case, and since Congress has authorized the Secretary to resolve this

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[19] "Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code." *United States* v. *Correll*, 389 U.S. at 307. Deference to the agency's interpretations "helps guarantee that the rules will be written by 'masters of the subject,' *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979).

matter prospectively in legislative rules adopted under Section 1502, it is not necessary for the Court to attempt at this time to anticipate the Secretary's eventual ruling on that issue.

B. *Petitioner Is Not Entitled To The Product Liability Loss Deductions That It Claims In This Case*

Petitioner is wrong in contending that the court of appeals committed a "fundamental error" by "think[ing] of the issue in this case as involving the taxpayer's right to a deduction" (Pet. Br. 29). Petitioner cannot recover on its refund claims in this case unless it is allowed to carry back to its consolidated returns for 1973-1976 the same product liability expenses that have already been deducted in determining the *positive* net incomes of its profitable affiliates in the years 1983-1986. In *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 66 (1934), this Court held that an affiliated group that files a consolidated return is not entitled to a claimed deduction in the absence of a statutory provision or a consolidated return regulation "that fairly may be read to authorize it." That principle is dispositive of this case, for both the statute and the regulations preclude the double application of the deduction that petitioner proposes.

1. The text of Section 172 directs that product liability expenses be calculated at the individual taxpayer level and be applied first against the current income of that entity. By directing that product liability expenses be based on the "liability of the taxpayer" (26 U.S.C. 172(j)(2)(A)) and be reduced from the current income of that same "taxpayer" in calculating the "net operating loss" of that taxpayer (26 U.S.C. 172(j)(1)), Section 172 confines the benefit of an extended carryback of losses to the entity that is itself

liable for these product liability expenses. The statute has no application to, and provides no extended carryback benefits for, any affiliates of that taxpayer that are not themselves subject to such product liability.

Petitioner is incorrect in asserting (Pet. Br. 25-26) that, as applied to a consolidated group of corporations, the "taxpayer" to whom the Section 172 scheme applies is the consolidated group. Section 7701(a)(14) of the Code generally specifies that the term "taxpayer" as used in the Code means "any person subject to any internal revenue tax." 26 U.S.C. 7701(a)(14).[20] Even though separate affiliated taxpayers may join in filing a consolidated return, the resulting tax liability is not a liability of the "group." Instead, it attaches directly to each of the individual taxpayers that are members of the group, who are severally liable for the tax incurred. 26 C.F.R. 1.1502-6(a). As this Court has emphasized, while a consolidated group files a return that aggregates information developed from the various separate affiliates, "[t]he fact is not to be ignored that each of [the] corporations joining * * * in a consolidated

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[20] Section 7701(a)(1) of the Code provides that, "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof," "[t]he term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." 26 U.S.C. 7701(a)(1). By contrast, an affiliated group is defined for purposes of the Code as "1 or more *chains* of includible corporations connected through stock ownership with a common parent corporation * * *." 26 U.S.C. 1504(a)(1)(A) (emphasis added). Cf. *First Chicago NBD Corp.* v. *Commissioner*, 135 F.3d 457, 458 (7th Cir. 1998) (holding that a statute that referred to "a" corporation did not include an affiliated group of corporations that filed a consolidated return).

return is none the less a taxpayer." *Woolford Realty Co.* v. *Rose*, 286 U.S. at 328.

When Congress has decided to apply a particular provision of the Code that refers to a "taxpayer" directly to an affiliated group of corporations, it has done so expressly. For example, Section 172(h)(4)(C) of the current Code provides a special rule for net operating loss carrybacks of any "corporate equity reduction interest loss" authorized under Section 172(b)(1)(E). It states that, "[e]xcept as provided by regulations, all members of an affiliated group filing a consolidated return under section 1501 shall be treated as 1 taxpayer *for purposes of this subsection and subsection (b)(1)(E).*" 26 U.S.C. 172(h)(4)(C) (1994 & Supp. IV 1998) (emphasis added). See also 26 U.S.C. 860E(a)(2) (1994 & Supp. IV 1998) ("All members of an affiliated group filing a consolidated return shall be treated as 1 taxpayer *for purposes of this subsection.*") (emphasis added); 26 U.S.C. 860J(d) (Supp. IV 1998) ("All members of an affiliated group filing a consolidated return shall be treated as one taxpayer *for purposes of this section.*") (emphasis added). Congress has not enacted similar language in Section 172 to provide for the carryback of product liability losses on a consolidated, rather than individual "taxpayer," basis. Although it is obvious that Congress knows how to provide for consolidated treatment of the special net operating loss provisions of Section 172 when it desires to do so, Congress made no such provision for the "product liability loss" carryback established under Section 172(j).

The "taxpayer" referred to in Section 172(j) is thus the corporation that itself has incurred product liability expenses and is unable fully to utilize them due to an insufficient amount of current income. Congress was concerned with smoothing the accounting of the income

and expenses of the individual entity that is liable for product liability expenses. The statute is not designed to provide tax benefits for affiliated entities that (either by corporate design or by historical fact) themselves have no liability for these expenses. As the sponsor of this legislation explained (124 Cong. Rec. at 34,733 (Sen. Culver) (emphasis added)):

> The amendment would allow businesses to "carry back" product liability losses and apply them against taxable income for the 10 preceding years. This is an extension specifically for product liability losses 7 years beyond the 3-year period permitted for most business losses. By allowing businesses to use previous taxable income as at least a partial reserve against major product liability losses, the amendment would help assure that *a business which suffered a major product liability loss* would have the funds both to stay in business and provide reasonable compensation to injured consumers.

It is the "business which suffered [the] loss"—rather than the affiliates of that business which, due to their separate corporate existence, are not themselves liable for the loss—that the statute is designed to assist.

In enacting the "product liability loss" provision, Congress sought to assist only those corporations that experience financial difficulties from product liability. Congress did not provide any benefit to a profitable corporation even though that corporation might have had large product liability expenses. 26 U.S.C. 172(j)(1). The ten-year carryback authorized by Section 172(j) applies only when the product liability expenses cannot currently be utilized as deductions by the corporation because it incurred a net *loss* in the current period. *Ibid.* After a profitable corporation employs its

product liability expense deductions to reduce its net income in the current period, there are no remaining unused deductions—or "product liability losses"—for it to pass on to its affiliates either as current deductions on the consolidated return or as a carryback to prior years under Section 172(j). See pages 16-18, *supra*.

2. For these same reasons, petitioner errs in contending that the fact that the consolidated return regulations ultimately yield a "consolidated" net operating income or loss means that the "product liability loss" provisions are to be applied *only* at the consolidated level. Pet. Br. 14-19. The consolidated net operating loss that is calculated under 26 C.F.R. 1.1502-21(a) is obtained only after first determining, and then aggregating, the "separate taxable income" of each separate affiliate. Although a few specific items (such as capital gains and charitable deductions) are treated as consolidated, rather than separate items, product liability expenses are treated initially at the separate entity level. Under the "separate taxable income" approach of the regulations, product liability expenses are first deducted against the current income of the individual affiliates that incurred them. See page 21, *supra*. As the court of appeals correctly concluded in this case, the requirement of the consolidated return regulations that a "separate taxable income" be computed for each affiliate "makes clear that blending those expenses is not permitted, *i.e.*, that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated 'product liability loss' is not intended." Pet. App. 16a. Instead, first "determining 'product liability loss' separately for each group member is correct and consistent with the regulations." *Id.* at 17a.

By contrast, petitioner is seeking to amend the consolidated return regulations to provide, as an additional "consolidated item" under 26 C.F.R. 1.1502-12, a consolidated, rather than separate, product liability expense deduction. On petitioner's theory of this case, the product liability expenses of each member of the group would be treated in the same manner as charitable deductions, capital gains and the other consolidated items specified in the regulations. See pages 22-23, *supra*. Under that theory, each member would compute its separate taxable income *without* taking into account its product liability expenses, and those expenses would instead be utilized as deductions only at the consolidated level.

The rule that petitioner proposes plainly conflicts with the express requirements of the regulations that the Secretary has promulgated under the broad authority of Section 1502. Under those regulations, each member of an affiliated group must take its product liability expenses into account in computing its "separate taxable income." See page 21, *supra*. Moreover, petitioner's attempt to aggregate those same expenses and take them into account only at the consolidated level also conflicts with the fundamental objectives of the statute, which seeks to provide benefits only for a business that itself incurs product liability expenses. 26 U.S.C. 172(j)(2). The statute is not designed to provide benefits for other corporations or affiliates which, either by intentional corporate design or historical accident, shoulder none of that exposure.[21]

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[21] Petitioner errs in asserting (Pet. Br. 22) that the Commissioner's position "ascribes overwhelming tax significance to the organizational structure of the taxpayer's business" and produces "a result that is completely at odds with the underpinnings of the

Petitioner's efforts to use its consolidated return to accomplish a tax benefit that Congress did not intend thus suffers from the defect identified by this Court in *Woolford Realty Co.* v. *Rose*, 286 U.S. at 330. In rejecting the taxpayer's effort in that case to employ a consolidated return to take advantage of deductions that Congress had not intended to allow, the Court stated (*ibid.*):

> Submission to such mischiefs would be necessary if the statute were so plain in permitting the deduction as to leave no room for choice between that construction and another. Expediency may tip the scales when arguments are nicely balanced. True, of course, it is that in a system of taxation so intricate and vast as ours there are many other loopholes unsuspected by the framers of the statute, many other devices whereby burdens can be lowered. This is no reason, however, for augmenting them needlessly by the addition of another.

Petitioner's claim in this case should be denied because petitioner has failed to sustain its "burden of clearly showing the right to the claimed deduction" under either the statute or the regulations. *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943)). See also *Woolford Realty Co.* v. *Rose*, 286 U.S. at 330 (the statute is not "plain in permitting the deduction").

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consolidated tax return regime." The "product liability loss" provisions of Section 172 are not intended to provide benefits for corporations that, due to "the organizational structure" adopted by the affiliated enterprises, have kept themselves apart from any exposure to product liability claims. See page 32, *supra*.

3. Petitioner errs in asserting (Pet. Br. 19-20) that its approach in this case is "perfectly in harmony" with positions taken by the Internal Revenue Service in prior agency rulings. Petitioner fails to acknowledge that, in Technical Advice Memorandum 97-15-002 (Apr. 11, 1997), the Service addressed the very issue presented in this case and specifically rejected the approach advocated by petitioner.[22] Moreover, the authorities that petitioner cites are simply unrelated to the issues presented in this case. The Notice of Proposed Rulemaking cited by petitioner (Pet. Br. 20-21) merely makes the unremarkable observation that, under the governing regulations (26 C.F.R. 1.1502-11 & 12), corporations that file a consolidated return are to combine their separate income and losses to arrive at a single consolidated income (or loss) for the group.[23] 56 Fed. Reg. 4229 (1991). As we have described in detail, however, these same regulations require each individual corporation with product liability expenses first to claim and utilize those deductions in computing its "separate taxable income." See pages 21-23, *supra*. The "separate taxable income" calculated independently for each of the several affiliates is *thereafter* combined to derive a consolidated income figure. *Ibid.* When, as in this case, the product liability expenses are

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[22] The technical advice memoranda and similar agency documents cited by petitioner have no precedential weight, and Congress has specified that such informal written determinations "may not be used or cited as precedent." 26 U.S.C. 6110(k)(3) (Supp. IV 1998). We cite them here only to address petitioner's misuse of these documents.

[23] Private Letter Ruling 88-16-002 (Dec. 31, 1987), which is cited by petitioner (Pet. Br. 19), similarly notes that an affiliated group computes a consolidated net operating loss *after* the separate taxable income of each affiliate is first determined.

fully utilized as deductions at the separate entity level, there are no remaining deductions—or "product liability losses"—to be passed on and employed at the consolidated level.

4. The Sixth Circuit erred in *Intermet Corp.* v. *Commissioner*, 209 F.3d 901 (2000), in reaching the contrary conclusion. Although the court stated in *Intermet* that the consolidated return "regulations do not specifically address" the application of the special ten-year carryback for a "specified liability loss" in the consolidated return context (209 F.3d at 905; see note 1, *supra*), the court ultimately concluded that this issue should be resolved by a provision in the regulations that neither party had cited. That regulation is 26 C.F.R. 1.1502-80(a), which specifies that "[t]he Internal Revenue Code, or other law, shall be applicable to the [consolidated] group to the extent the regulations do not exclude its application." The court in *Intermet* reasoned that, because the consolidated return regulations provide no specific rule for the treatment of product liability expenses, the entire affiliated group must be treated as a single "taxpayer" for purposes of Section 172(f). 209 F.3d at 906, 908.[24] The court stated that it found nothing in the regulations that modified the "default rule" in 26 C.F.R. 1.1502-80(a) that

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[24] The unexplained assertion of petitioner that "the Sixth Circuit did not rely on Treas. Reg. § 1.1502-80 to resolve the issue before it" (Pet. Br. 24) is refuted by the direct citation of that provision, and the direct reliance upon that provision, in the court's opinion. See 209 F.3d at 905-908. For example, the court of appeals stated that, "[t]o assess Intermet's position, the consolidated return regulations direct us first to determine whether the group, as opposed to its individual members, satisfies the Code's requirements for the SLL carryback. *See* Treas. Reg. § 1.1502-80(a)." 209 F.3d at 905-906.

requires the consolidated group to be treated as if it were a single taxpayer. 209 F.3d at 908.

The Sixth Circuit erred in its construction of this regulation. The regulation simply specifies that the usual rules found in the Internal Revenue Code, or other sources of law, apply to an affiliated group of corporations unless the consolidated return regulations exclude their application. 26 C.F.R. 1.1502-80(a). The usual rules of the Internal Revenue Code require each corporation to be treated as a separate taxpayer. See 26 U.S.C. 11(a). The usual rule incorporated into the consolidated return regulations is thus that the separate status of every corporation continues to be recognized except as the consolidated return regulations otherwise provide.[25] See also 26 C.F.R. 1.1502-12 ("[t]he separate taxable income of a member * * * is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations"). As this Court stated in *Helvering* v. *Morgan's, Inc.*, 293 U.S. 121, 127 (1934), "[a]fter affiliation, as before, the affiliated corporations, although filing consolidated returns, continued to be separate taxable units." See also *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436, 440 (1943) (an affiliated corporation is "as much a separate entity as if its stock had been transferred * * * to third persons"); *In re Chrome Plate, Inc.*, 614 F.2d 990, 996

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[25] The example provided in the very next sentence of the regulation relied on by the court of appeals in *Intermet* makes clear that specific provisions of the Code continue to apply directly to individual members of the group when the consolidated return regulations have not specified otherwise. 26 C.F.R. 1.1502-80(a) ("[f]or example, in a transaction to which [26 U.S.C.] 381(a) applies, the acquiring corporation will succeed to the tax attributes described in section 381(c).").

(5th Cir. 1980) ("[t]he filing of [a consolidated return] * * * is insufficient to destroy the separate existence of the corporations").

It has thus long been held that the "general rule" established by this regulation is that, "to the extent the consolidated return regulations do not mandate different treatment, corporations filing consolidated returns are to be treated as separate entities when applying other provisions of the Code." *Gottesman & Co.* v. *Commissioner*, 77 T.C. 1149, 1156 (1981). Under 26 C.F.R. 1.1502- 80(a), "[w]here the consolidated return regulations do not require that corporations filing such returns be treated differently from the way separate entities would be treated, these corporations shall be treated as separate entities when applying provisions of the Code." *H Enterprises International, Inc.* v. *Commissioner*, 105 T.C. 71, 85 (1995).[26] The court of appeals erred in *Intermet* by giving this

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[26] Petitioner acknowledges that, under the general rule of 26 C.F.R. 1.1502-80(a), "corporations filing consolidated returns are to be treated as separate entities to the extent that the consolidated return regulations do not require otherwise" (Pet. Br. 25). Petitioner merely contends that treating the members of an affiliated group as separate entities "is not tantamount to saying that product liability losses must be determined on a separate company basis because the consolidated return regulations do not contain specific words requiring that such losses be computed on a consolidated basis" (*ibid.*). In making that assertion, however, petitioner fails to account for the fact that the consolidated return regulations specify that product liability expenses must *first* be applied at the separate entity level and that only the unconsumed portion of such expenses may thereafter be applied at the consolidated level. See 26 C.F.R. 1.1502-12 & 21; pages 21-23, *supra*. Because all of the product liability expenses involved in this case were utilized at the separate entity level, there are no "product liability losses" to reach the consolidated return.

regulation an interpretation that simply turns its established meaning upside down.

As we have noted, no member of petitioner's affiliated group would have incurred a "product liability loss" under Section 172(j) if it had filed a separate return during the years in issue. See pages 7, 18 & note 14, *supra*. Application of the general rule of 26 C.F.R. 1.1502- 80(a) to this case would thus support rejection, rather than acceptance, of petitioner's claim. But there is, in any event, no need to rely on any "general" or "default" rule in this case, for the plain text of the regulations requires all product liability expenses first to be deducted in determining the separate income of the individual affiliate that incurred those expenses. 26 C.F.R. 1.1502-12(a); see pages 21-23, *supra*. On the facts of this case, there are no unutilized deductions at that level because each of these affiliates earned a profit during the relevant years. There are thus no "product liability losses" from these profitable affiliates to carry to the consolidated level or to carry back to prior years.

5. The rule that petitioner advocates would permit significant tax avoidance abuses. Under petitioner's approach, a corporation that is currently unprofitable but that had substantial income in prior years could (i) acquire a profitable corporation with product liability expense deductions in the year of acquisition, (ii) file a consolidated return and (iii) thereby create an otherwise nonexistent "product liability loss" for the new affiliated group that would allow the acquiring corporation to claim refunds of the tax it paid in prior years.[27] Neither the terms nor the purpose of the

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[27] For example, a manufacturing company (with prior profits and current losses) that has no product liability exposure could

consolidated return regulations authorize that sort of "juggling" and trading of corporate tax attributes.[28] It is precisely because "[t]he mind rebels against the notion" that "an opportunity for juggling so facile and so obvious" should be permitted (*Woolford Realty Co.* v. *Rose*, 286 U.S. at 330) that Congress directed the Secretary to ensure that the consolidated return regulations be designed "to prevent avoidance of such tax liability." 26 U.S.C. 1502.

The result advocated by petitioner thus would not only contravene the text and intent of the product liability loss provisions in Section 172(j). It would also contravene the clear admonition of Congress, and of

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purchase a tobacco company (with both prior and current profits) that has significant product liability expenses. The combined entity could, on petitioner's theory, assert a ten-year carryback of "product liability losses" even though the tobacco company has always made a profit and never incurred a "loss" of any type. See also note 28, *infra*.

[28] In this respect, the anti-abuse regulation on which the court of appeals relied (26 C.F.R. 1.1502-79) reveals a fundamental flaw in petitioner's position. Four of the members of petitioner's affiliated group that computed positive separate taxable income and claimed product liability deductions between 1983 and 1986 (Jesco, Amtel, Litwin and Panamerican) were *not* members of petitioner's affiliated group during the years to which petitioner seeks to carry back its alleged product liability losses. It is clear under the anti-abuse regulation that, if those corporations had incurred "separate net operating losses" during the period from 1983 to 1986, those losses could have been carried back only to their *separate* return years under 26 C.F.R. 1.1502-79(a)(3) and could *not* have been carried back and used by petitioner. See notes 4, 6, *supra*. There is no logical reason why petitioner should be able to use these deductions to create product liability "losses" for itself simply because the affiliated corporations that actually incurred the product liability expenses realized profits instead of "losses."

this Court, that consolidated returns not be employed as an artifice to evade taxes.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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IN THE

Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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CORPORATE DISCLOSURE STATEMENT

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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ARGUMENT

A. The Deduction Of Product Liability Expenses In The Computation Of The Positive Separate Taxable Income Of A Member Of An Affiliated Group Does Not Preclude Those Expenses From Being Taken Into Consideration In Computing The Affiliated Group's Product Liability Loss.

Respondent's primary argument rests on a single, flawed premise. According to respondent, any product liability expenses of a member of an affiliated group with positive separate taxable income are somehow "consumed" or used up in the computation of that income, and no longer exist to be taken into consideration in computing the group's product liability loss. (Res. Br. 16-24, 27-28, 33-34.) The Sixth Circuit flatly and persuasively rejected this argument in *Intermet Corp. v. Commissioner,* 209 F.3d 901, 906-907 (6th Cir. 2000) (Pet. App. E at 71a):

> While we agree with the IRS's overall description of the consolidated return regulations, we reject its analysis. A member's STI [separate taxable income] is simply a step along the way to calculating the group's taxable income or CNOL [consolidated net operating loss]. An STI has no other purpose. More to the point, the regulations prescribing the calculation of STI and CNOL do not govern the determination of CNOL carrybacks. That issue is governed by Treas. Reg. § 1.1502-21A(b), which applies the principles of section 172 to the consolidated NOL of the group, rather than separate member "NOL's" or STIs, in situations such as this one, which do not involve separate return years. In addition, the IRS and the Tax Court perceive a distinction between positive

> and negative STI that is unsupported by the regulations. An STI's character as positive or negative has no independent significance — either for purposes of calculating CNOL or otherwise. A member's SL [specified liability] expenses[1] affect the group's CNOL dollar-for-dollar, and it makes no difference whether the member has a positive or negative STI. Because neither the purpose nor the language of the consolidated return regulations provide a basis for concluding that the member's SL expenses are "exhausted" when the member has a positive STI but remain when the member has a negative STI, we find that the IRS's interpretation is unreasonable.

Contrary to respondent's assertion, after the product liability deductions of a member of an affiliated group with positive separate taxable income are used mathematically to offset income of that member in arriving at the amount of its separate taxable income, using that member's product liability deductions in the comparison of the group's total product liability deductions with its consolidated net operating loss is both permissible and appropriate.

Without question, the amount of the product liability deductions in issue had a direct effect on the amount of the AMCA group's consolidated net operating losses for the years in which such losses arose, and were taken into consideration in determining the amount of those losses regardless of the fact that this was accomplished in a two-step process of (1) determining separate taxable income, followed by (2) determining consolidated taxable income. Respondent's "consumed" argument therefore should be rejected. *See* Lawrence M. Axelrod and Jeremy B. Blank,

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1. Specified liability expenses in *Intermet* are the exact equivalent of product liability expenses in this case.

The Supreme Court, Consolidated Returns, and 10-Year Carrybacks, 90 Tax Notes, Number 10, 1383, 1394 (hereinafter "Axelrod").

B. There Is No Double Deduction.

The Court understandably would not want to be in the position of sanctioning a rule that provides taxpayers with double deductions. In an attempt to bolster the flawed argument discussed above, respondent claims that petitioner will secure a double deduction if its position in this case is sustained. (Res. Br. 16, 29.) This is a demonstrably false contention.

Assume an affiliated group consisting of two corporations, A and B. A has positive separate taxable income of 100 after having taken into consideration product liability deductions of 200. B has negative taxable income of 500, having had no product liability deductions. The group unquestionably has a consolidated net operating loss of 400 which can be carried to some other year.

In this example, the first thing to note is that the net operating loss of 400 produces no tax benefit until it is applied to reduce income in another year. In and of itself, it creates no tax benefit; it is simply a loss. Bearing that fact in mind, assume that A's product liability deductions of 200 had not existed. In that case its separate taxable income would have been 300 and the consolidated net operating loss of the group would have been reduced to 200. As in the case of the 400 loss, the affiliated group pays no income tax for the year in which the loss arises, and the 200 loss creates no tax benefit until it is applied against income in another year.

Thus, whether or not the affiliated group in this example has a deductible product liability expense of 200 in the first

instance, that deduction produces no benefit unless and until the group's consolidated net operating loss reduces the group's income in some other year. Only at that time will the group receive a single tax benefit for its product liability expenses. *Intermet v. Commissioner*, 209 F.3d 901, 908 (6th Cir. 2000). (Pet. App. E at 75a.)

The pivotal point is that, if respondent prevails, the AMCA group will be entitled to the identical consolidated net operating loss carryover it will be entitled to if petitioner prevails. The only thing that changes is the year to which a portion of that loss can be carried to offset other income. It is preposterous to claim that, if AMCA obtains a tax benefit by deducting its consolidated net operating loss against the income of a year that would satisfy the respondent, it does not obtain a double deduction of any product liability expenses while, at the same time, contending that a deduction of that same loss against the income of a different year yields a second deduction of those same product liability expenses.

There is only one deduction of the product liability expenses in either case. The parties are simply at odds as to the year in which AMCA is entitled to claim the deduction, and they are at odds in this regard solely because of a combination of tax rate changes and the time value of money, not because the petitioner is attempting to claim the same deductible item twice. If it were not for the noted tax rate changes and time value of money considerations, this case would not exist. *This case involves only the issue of when a taxpayer can claim a deduction; it has absolutely nothing to do with whether the taxpayer is entitled to the deduction in the first instance.* Axelrod at 1394.

C. The AMCA Affiliated Group Is Properly Regarded As The Taxpayer For The Purpose Of Applying Section 172(j)(1).

In its Brief, petitioner explained why the AMCA group should be treated as a single taxpayer for purposes of applying section 172(j)(1) (Pet. Br. 25-27), as held by the Sixth Circuit Court of Appeals in the *Intermet* case (Pet. App. E at 74a). In opposition to this contention, respondent cites *Woolford Realty Co. v. Rose*, 286 U.S. 319 (1932),[2] a case that is readily distinguishable. (Res. Br. 11-12, 30-31.)

Woolford Realty involved Woolford Realty's acquisition of Piedmont Savings Co. in 1927. The two corporations filed a consolidated federal income tax return for that year under § 240 of the Revenue Act of 1926. Prior to the merger, Piedmont had incurred losses in 1925 and 1926 which it attempted to carry over to the affiliated group's 1927 consolidated return. Piedmont had a loss in 1927 as well as in 1925 and 1926. At the time, the consolidated return regulations contained no provision comparable to Treas. Reg. § 1.1502-21(c), addressing the carryover of losses from what came to be called a separate return year to a consolidated return year. That regulation limits such carryovers to the amount of income generated during the consolidated return year by the group member that incurred the loss in the separate return year, the rule adopted in *Woolford Realty*.

To reach that result, the Court decided that, absent any factor indicating a contrary result, the rules applicable to

2. Respondent also cites *Helvering v. Morgan's, Inc.*, 293 U.S. 121, 127 (1934), and *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 440 (1943). (Res. Br. 38.) Petitioner's argument with respect to *Woolford Realty* applies with equal force to *Helvering v. Morgan's*. *Moline Properties* is miscited because it has nothing to do with affiliated corporations, as that term is used in this case.

the carryover of net operating losses from separate return years to consolidated return years had to be analyzed on a separate company basis. In support of its position, the Court stated that a corporate member of an affiliated group does not cease to be a taxpayer by the fact of affiliation. 286 U.S. at 328.

Relying on this statement, respondent contends that the AMCA affiliated group cannot be viewed as a single taxpayer. This argument does not withstand scrutiny. First, the Court's conclusion that each member of an affiliated group remains a separate taxpayer properly should be viewed as *dictum*. The statement was unnecessary to the Court's decision which was already established by the Court's conclusion that there was no statutory or regulatory support for Woolford Realty's position.

Second, while the Court in *Woolford Realty* held that the members of the group had to be treated as separate entities for the purpose of establishing a rule for the carryover of net operating losses from a separate return year to a consolidated return year, it never held that members of an affiliated group must be treated as separate taxpayers for all purposes. The Internal Revenue Service clearly has never read *Woolford Realty* to stand for such a proposition, as is evidenced by the many examples provided both in petitioner's Brief (26-27) and the Brief of the *Amici Curiae* (6-7), in which the Internal Revenue Service has treated an affiliated group as a single taxpayer.

Even prior to the *Woolford Realty* decision, the Internal Revenue Service had promulgated a regulation on January 3, 1929, also dealing with the carryover of net operating losses by affiliated groups of corporations filing consolidated income tax returns, in which the Service provided that, under certain conditions, a carryover of a net operating loss by an

affiliated group was to be determined "in the same manner, to the same extent, and upon the same conditions as if such group were a single corporation and the same taxpayer. . . ." Regulations, 75, Art. 41(b) (1929). This regulation was upheld in *S. Slater & Sons, Inc. v. White*, 119 F.2d 839 (1st Cir. 1941), in which *Woolford Realty* was considered in detail.

The First Circuit rejected the taxpayer's argument that *Woolford Realty* precluded treating an affiliated group as a single taxpayer, noting that a new revenue act had been enacted, new income tax regulations had been issued and, most tellingly, when *Woolford Realty* "applied a consistent separate-taxpayer theory for purposes of the two-year carry-over, there was no occasion to compute a 'consolidated net loss' as we have above indicated." *Id.* at 845. The court added that "[t]he single-taxpayer theory has the merit of simplicity, and it also conforms to business reality." *Id.* at 843.

In short, although the separate taxpayer approach made perfect sense in *Woolford Realty,* the Court certainly never indicated that this approach was to have universal application in all consolidated return situations regardless of the specific issue involved. Notwithstanding *Woolford Realty*, the Internal Revenue Service has never expressed a belief that there is a universal rule requiring every member of an affiliated group to be treated as a separate taxpayer for all consolidated return purposes. Admittedly, there are situations when this is appropriate, typically when carrying losses from separate return years to consolidated return years or from consolidated return years to separate return years. In the overwhelming number of situations involving tax consequences that remain wholly within the affiliated group, however, the Internal Revenue Service has chosen to treat an affiliated group as a single taxpayer, a treatment clearly envisioned by Congress.

When consolidated returns were first permanently introduced into the tax law by section 240 of the Revenue Act of 1919[3], the Senate Committee on Finance, then considering the Revenue Bill of 1918, stated:

> While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but *because the principle of taxing as a business unit what in reality is a business unit is sound and equitable* and convenient both to the taxpayer and to the Government.

S. Rep. No. 617, 65th Cong. 3d Sess. (1918); 1939-1 C.B. (Part 2) 117, 123 (emphasis added).

When the Revenue Act of 1928 was under consideration, a proposal was made by the House of Representatives to eliminate consolidated income tax returns. The Senate Committee on Finance rejected this notion, stating:

> Inasmuch as there is apparently some misunderstanding as to the effect of the House bill and as to what consolidated returns really are, it seems advisable at this time to discuss the subject somewhat at length.
>
> After the enactment of the profits tax of 1917, a committee, consisting of members of the Committee on Ways and Means of the House, of the Committee on Finance of the Senate, and of

---

3. Consolidation had been authorized on a trial basis by the Revenue Act of 1917.

leading experts, was engaged in the preparation of regulations to carry out the Act. As a result of a very careful and nonpartisan consideration of the subject by this committee, the Treasury authorized the filing of consolidated returns by corporations which, by reason of common ownership, were affiliated — that is, although composed of several corporate entities, were as a practical matter but one corporation. . . .

* * *

The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have realized no gain. The failure to recognize the entire business enterprise means drawing technical legal distinctions as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. It would be just as unreasonable

> to demand that an individual engaged in two or more businesses treat each business separately for tax purposes.

S. Rep. No. 960, 70th Cong., 1st. Sess., at 13-14 (1928); 1939-1 C.B. (Part 2) 409, 417-418.

D. The *Amtel* Case Did Not Address The Issue In This Case.

Respondent erroneously cites *Amtel, Inc. v. United States*, 31 Fed. Cl. 598 (1994), *aff'd without opinion*, 58 F.3d 181 (Fed. Cir. 1995), as supporting its position. (Res. Br. 6-7, 24-25.) That case never addressed the question presented to this Court. *Amtel* asked whether a member of an affiliated group with positive separate taxable income earned in a year in which the affiliated group of which it was a member had a consolidated net operating loss could, by using the 10-year carryback rule, carry back to a *separate return year* (*i.e.*, a year in which the member with the positive separate taxable income was not a member of the consolidated group and filed a separate tax return) a portion of the affiliated group's net operating loss as a product liability loss. By contrast, the current case asks whether an affiliated group can carry back a product liability loss *to one of its own consolidated return years.*

Although both cases involve the carryback treatment of a portion of a consolidated net operating loss when deductions included in the computation of that loss are incurred by a group member with positive separate taxable income, they present completely different issues.

In deciding *Amtel*, the Court of Federal Claims defined the issue before it as whether a member of an affiliated group was entitled to carry back a portion of the group's

consolidated net operating loss to offset income previously reported by that member on a separate return. 31 Fed. Cl. at 599. The only analysis the court required to deny the carryback in issue was that the Treas. Reg. § 1.1502-79(a)(3) formula did not operate any differently with respect to the 10-year carryback rule for losses attributable to product liabilities than it did with respect to consolidated net operating losses in general. *Id.* at 600.

Respondent attempts to leverage its reliance on *Amtel* by arguing that, if the AMCA group could not carry product liability deductions to a separate return year, there is no reason why it should be able to carry them back to a consolidated return year. (Res. Br. 41, n.28.) This contention misses the mark for two reasons.

First, the AMCA group, whether in the context of this case or of *Amtel*, had a fixed consolidated net operating loss in each year in issue. For the taxpayer to have prevailed in *Amtel*, it would have to have demonstrated that, without regard to product liability expenses, some portion of AMCA's net operating loss properly could be carried back to a separate return year. This it could not do. Thus, Amtel was not even entitled to carry any loss back three years, much less 10 years. That result is the sum and substance of what was held in the *Amtel* case. Any language relating to "consolidated product liability deductions," apart from being misdirected for the reasons stated in petitioner's Brief (27-29), was pure *dictum*.

Second, the fact that some members of the AMCA affiliated group were not members of the group for the entire 10-year period in issue, a factor made much of by respondent (Res. Br. 7, n.6, 40-41, n.28), is a red herring. Neither court below ever took this point into consideration in its decision. Further, the United States has never before raised this as an issue (quite properly so) because there is no provision in

either the Internal Revenue Code or the consolidated return regulations to support such a position.

Any time a new member of an affiliated group has a deduction that contributes to the group's consolidated net operating loss, that loss can be carried back to an earlier consolidated return year of the group preceding the affiliation of the new member if that member has positive separate taxable income. Thus, there is absolutely nothing unique about deductions of a new member of an affiliated group being included in the carryback of a consolidated net operating loss to an earlier consolidated return year of the group when the member generating the deductions was not yet a member. Accordingly, the question of whether to apply the section 172, 10-year carryback rule on a group-wide basis, as opposed to a separate company basis, does not turn in any conceivable way upon the fact that a member of the affiliated group with product liability deductions was not a member of the group for the entire 10-year period.

Respondent's contrived hypothetical situation (Res. Br. 40, n.27), designed to worry the Court that a general decision in favor of treating the affiliated group as a single entity for 10-year carryback purposes will open the door to tax abuse, is based on a highly unlikely set of circumstances that assumes the equally unlikely willingness of a corporation to acquire another corporation faced with the prospect of inordinately large liabilities of an unknown magnitude. In any event, there is certainly not a shred of evidence in this case that AMCA acquired affiliates to create 10-year carrybacks.[4]

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4. Significantly, respondent fails to acknowledge section 269 of the Code, which already provides the Service with ample authority to disallow the benefits of any deduction, credit or allowance of any corporation that acquires another for the principal purpose of evading Federal income tax.

E. In The Absence Of Clear Guidance, Petitioner's Position Represents The Most Appropriate Basis For Deciding This Case.

Neither the Internal Revenue Code nor the consolidated return regulations contain a specific rule that addresses the facts before the Court. Under these circumstances, respondent is asking this Court to sanction a departure from the consolidated net operating loss structure established by the Internal Revenue Service for no other reason than to enrich the fisc.

Respondent attempts to support its position with a resort to the statutory construction doctrine termed *expressio unius est exclusio alterius* or "the expression of one thing is the exclusion of another." Thus, at page 31 of its Brief, respondent notes three instances in which Congress specifically provided for the treatment of an affiliated group as a single taxpayer, and then argues that the failure of Congress to provide the same in connection with section 172(j)(1) must be read as Congressional intent to apply that section to affiliated groups on a company-by-company basis.

This contention fails on two grounds. First, the Court has long noted that the *expressio unius* rule must be applied with great caution. In *Ford v. United States*, 273 U.S. 593, 612 (1927) (quoting *Colquhoun v. Brooks*, L.R. 21 Q.B Div. 52, 65), the Court, speaking of this rule, stated:

> It is often a valuable servant, but a dangerous master to follow in the construction of statutes or documents. The *exclusio* is often the result of inadvertence or accident, and the maxim ought not to be applied, when its application, having regard to the subject-matter to which it is to be applied, leads to inconsistency or injustice.

In an article in the Harvard Law Review, Professor Max Radin of the University of California School of Jurisprudence, addressing the rule, after referring to it as "one of the most fatuously simple of logical fallacies, the 'illicit major,' long the *pons asinorum* of schoolboys," stated:

> It must be clear that the only value which such a maxim or axiom or rule could have would lie in the existence of an infallible or approximately infallible test of its applicability. Emphasis will help us in ordinary speech, but except for such inferred emphasis as the general purpose of the act will enable us to apply, no other stress on the words will be apparent in the printed page. The question will accordingly be in every case, not whether or not the expression of one thing excludes everything else, but whether we are to deny or affirm it for some other reason than its axiomatic force, and it will be necessary to search for that other reason.

Statutory Interpretation, 43 Harv. L. Rev. 863, 874 (1930); *see also* Axelrod at 1391-1392.

Second, the *expressio unius* rule is particularly inappropriate in this case because the sections cited by respondent, which include the single taxpayer language, are each provisions designed to deny tax benefits to taxpayers, not to provide them. Section 172(h) was introduced into the Internal Revenue Code to limit the inclusion in net operating losses of a certain type of interest. The rule could have been avoided by affiliated groups if it was not applied on a single entity basis. For instance, section 172(h)(2)(D) provides a $1 million *de minimis* exclusion from the application of the interest disallowance rule for each "taxpayer." If this exclusion were applied on a separate company basis, an affiliated group could create an infinitely expandable exclusion for itself.

The same reasoning applies to section 860E(a), a provision designed to insure that investors in real estate mortgage investment conduits, or REMICs, would report a certain minimum income that could not be reduced by net operating losses. Congress determined that single taxpayer treatment for affiliated groups was necessary to preclude such groups from avoiding the rule in question. H.R. Rep. No. 795, 100th Cong., 2d Sess., at 82 (1988); S. Rep. No. 445, 100th Cong., 2d Sess., at 88 (1988). Section 860J, which is directly tied into section 860E(a), is also a restrictive section easily avoided by affiliated groups if they could treat each group member as a separate taxpayer.

That Congress would want to insure that taxpayers could not easily avoid tax raising provisions by treating the members of an affiliated group as separate taxpayers tells us absolutely nothing about what Congress might have intended with respect to a taxpayer relief provision.

Notwithstanding respondent's contention that petitioner has not carried its burden of proof (Res. Br. 35), petitioner has demonstrated that respondent's approach cannot comply with the requirements of section 172(j)(1). That section plainly requires a comparison of product liability deductions with a net operating loss. No affiliated group member's separate taxable income can equate with a net operating loss until manipulated in some manner through the creation by the courts of some newly-invented approach, not set forth in the consolidated return regulations, a fact fully recognized by the Fourth Circuit. (Pet. App. A at 19a-21a.)

Ultimately, what this Court is faced with is the job of filling a hole left by the Internal Revenue Service. This is not an isolated hole in the landscape, however, but part of a distinctive formation that should be filled in so as to leave it in harmony with its surroundings. In this regard, any

ambiguity should be charged against the creator of the hole, as the Tax Court noted in a case cited with approval by respondent, *Gottesman & Co. v. Commissioner*, 77 T.C. 1149 (1981).

In that case, the consolidated return regulations were unclear as to whether they were to be applied with respect to the accumulated earnings tax rules on a separate company or on a consolidated basis. The Commissioner opportunistically argued for consolidated treatment, but the Tax Court held that, in light of the lack of clarity in the regulations attributable to the Internal Revenue Service, the taxpayer should prevail:

> We cannot fault petitioner for not knowing what the law was in this area when the Commissioner, charged by Congress to announce the law (sec. 1502), never decided what it was himself. Petitioner had no reason to assume that the definition provided in the old regulations applied under the new regulations. In fact, for reasons already stated, petitioner had every reason to assume the opposite.
>
> Thus, we find that the Commissioner's regulations regarding the manner in which the accumulated earnings tax was to be imposed on corporations making consolidated returns were ambiguous during the years at issue. This ambiguity was of the Commissioner's making, and, as such, must be held against him. Petitioner's interpretation of these regulations was reasonable under the circumstances. We think that under these circumstances the failure of petitioner to comply with respondent's post hoc view of the regulations is an insufficient ground on which to

> impose the accumulated earnings tax, and we hold for the petitioner on the issues herein presented.

77 T.C. at 1157-1158 (citation omitted).

This conclusion is consistent with the rule of statutory construction which directs that remedial tax provisions be construed liberally in favor of taxpayers. *Mertens Law of Fed Income Tax*, § 3.52, and citations contained therein; *cf. Bowers v. New York & Albany Lighterage Co.*, 273 U.S. 346, 350 (1927); *United States v. Updike*, 281 U.S. 489, 496 (1930).

CONCLUSION

For the foregoing reasons, petitioner respectfully requests that the Court reverse the decision of the United States Court of Appeals for the Fourth Circuit and reinstate the decision of the United States District Court for the Western District of North Carolina, which would result in the refund to petitioner of $1,618,306 of income tax, plus interest according to law.

Respectfully submitted,

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IN THE
Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF FOR THE NATIONAL ASSOCIATION OF MANUFACTURERS AND THE MANUFACTURERS ALLIANCE/MAPI INC. AS *AMICI CURIAE* SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether, in the case of an affiliated group that files a consolidated return, the existence of a product liability loss under 26 U.S.C. § 172(b)(1)(I)(1988) is determined by comparing (i) the income and expenses of the group as a whole, or (ii) the respective income and expenses of each of its members.

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INTEREST OF THE *AMICI CURIAE*

The National Association of Manufacturers ("NAM") is the nation's oldest and largest broad-based industrial trade association, representing 14,000 member companies and 350 member associations in every industrial sector of the national economy. NAM's mission is to enhance the competitiveness of manufacturers and to improve the living standards of working Americans by advocating a legislative and regulatory environment conducive to national economic growth. Many of NAM's members belong to affiliated corporate groups that file consolidated tax returns, and all of NAM's members have a significant interest in the administration of the tax laws.

The Manufacturers Alliance/MAPI Inc. ("MAPI") is a non-profit research and educational organization representing 450 multinational corporations drawn from a full range of manufacturing industries. For more than 66 years, MAPI's research has contributed to the development of the Internal Revenue Code in areas such as recovery of capital costs, credits, and loss carryovers.

NAM and MAPI (collectively, "amici") submit this *amicus curiae* brief to assist the Court in deciding the manner in which product liability losses are to be computed in the consolidated return context.[1]

STATEMENT

Title 26 U.S.C. § 1501 of the Internal Revenue Code (the "Code") provides that "an affiliated group of corporations" may file "a consolidated return with respect to the income tax

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[1] The United States and United Dominion, Inc. have consented in writing to the filing of this brief. The brief was not authored in whole or in part by counsel for either party. No person or entity, other than the amici curiae or their members, made a monetary contribution to the preparation or submission of this brief.

imposed by chapter 1 for the taxable year in lieu of separate returns." [2] Section 1502 in turn provides that the Secretary of the Treasury "shall prescribe such regulations as he may deem necessary" to determine and collect the income tax of an affiliated group that files a consolidated return. The Secretary has done so. *See* Treas. Reg. §§ 1.1502-1 to 1.1502-100.

This case concerns the application of 26 U.S.C. § 172(b)(1)(I)(1988) [3] to an affiliated group that files a consolidated return. Section 172(b)(1)(I) allows "a taxpayer" to carry back a "product liability loss" for up to 10 years before the year in which the loss is incurred. Section 172(j) defines the term "product liability loss" to mean "the lesser of" the taxpayer's product liability expenses and net operating loss for a particular year.[4]

The precise question presented by this case is whether, when an affiliated group files a consolidated return, § 172 requires a comparison of the product liability expenses and net operating loss of the group as a whole, or, alternatively, of the respective product liability expenses and net operating losses of each of the group's members. The Sixth Circuit

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[2] An "affiliated group" is one or more chains of corporations that are related through stock ownership of a common parent. *See* 26 U.S.C. § 1504.

[3] This case involves 26 U.S.C. § 172 and the consolidated return regulations in effect from 1983 to 1986. *See* United Dominion's Petition For A Writ Of Certiorari 1. The Sixth's Circuit's decision in *Intermet Corp. & Subsidiaries* v. *Commissioner*, 209 F.3d 901 (2000), involved the provisions in effect in 1992. *See id.* at 903. Although § 172 was amended in 1990, the amendment was technical as to the product liability loss subsection, and did not change the meaning of that term.

[4] Product liability expenses are defined by § 172(j)(1) to mean deductible expenses incurred in satisfying or defending product liability claims. "Net operating loss" is defined by § 172(c) to mean "the excess of the deductions allowed by this chapter over the gross income."

adopted the former, "consolidated" approach in *Intermet Corp. & Subsidiaries* v. *Commissioner*, 209 F.3d 901 (2000). The Fourth Circuit adopted the latter, "member-level" approach in this case. *See United Dominion Industries, Inc.* v. *United States*, 208 F.3d 452, 458 (2000), *cert. granted*, 531 U.S. __ (2000). The former, consolidated approach is correct.

SUMMARY OF ARGUMENT

Petitioner correctly argues that, under the text and policy of § 172 and the consolidated return regulations, the "taxpayer" whose product liability expenses and net operating loss are to be compared is the affiliated group, not each of its individual members. When an affiliated group files a consolidated return, the group as a whole is the taxpayer under the Code and the consolidated return regulations. Under those provisions, the group files a single, consolidated return; its tax liability is computed on a consolidated basis, with the corporate tax rate being applied to the total income of the group; its net operating loss is computed on a consolidated basis; and, subject to a limited exception not applicable here, that loss can only be carried back to prior return years by the group as a whole. *See* Treas. Reg. §§ 1.1502-75(a),-2(a),-11, -21(f),-21(a). Moreover, as applied in the consolidated return context, the term "taxpayer" as used in other sections of the Code is generally understood to refer to the group as a whole, rather than to its individual members.

When an affiliated group files a consolidated return, therefore, the calculation of the group's product liability loss involves a comparison of the group's product liability expenses and consolidated net operating loss. The latter item is expressly defined by Treas. Reg. § 1.1502-21(f), making this comparison a straightforward one. In addition, this approach is the only one consistent with the purpose of the consolidated return provisions of the Code, which is to treat

an affiliated group that files a consolidated return as a single business unit.

The contrary, member-level approach advocated by the United States and adopted by the Fourth Circuit is inconsistent with the text of § 172 and the consolidated return regulations. Under that approach, a group's product liability loss is the lesser of the aggregate of its members' product liability *losses* and the group's consolidated net operating loss. Section 172(j), however, requires a comparison of a taxpayer's product liability *expenses* and net operating loss. Product liability losses and product liability expenses are two different things, being separately defined under § 172(j). The member-level approach thus calls for a comparison other than the one specified in § 172(j).

The member-level approach is also incoherent. Because a group's net operating loss is computed on a consolidated rather than individual-member basis, *see* Treas. Reg. § 1.1502-21(f), the proponents of the member-level approach must articulate some measure to serve as the member's "net operating loss" for purposes of the § 172(j) comparison. The United States and the Fourth Circuit sharply disagree as to what this measure should be; and neither of the measures they propose withstand scrutiny.

Finally, the member-level approach is unworkable. It would enmesh taxpayers, the Internal Revenue Service (the "Service") and the courts in complex, subsidiary questions that simply do not arise under the more straightforward approach advocated by Petitioner and adopted by the Sixth Circuit. The most fundamental of these is discussed immediately above—concerning the measure to serve as the member's net operating loss—and even the United States and the Fourth Circuit do not agree on the correct answer. Moreover, the member-level approach would entail significantly increased administrative costs. Under that approach, product liability losses are computed on an

individual-member basis; hence the existence of a product liability loss may depend on whether a particular item of income or expense is attributed to one or another member of the group. Because affiliated groups tend to operate as a single business unit, these are factual questions as to which taxpayers and the Service can and will disagree.

In summary, the consolidated approach is consistent with the text of § 172 and the consolidated return regulations. It is also the simpler approach in practice. The member-level approach, in contrast, is an exercise in judicial legislation. It also presents serious practical difficulties. Thus, the member-level approach should be rejected, and the consolidated approach adopted.

ARGUMENT

WHEN AN AFFILIATED GROUP FILES A CONSOLIDATED RETURN, ITS PRODUCT LIABILITY LOSS UNDER 26 U.S.C. § 172 IS DETERMINED BY COMPARING THE INCOME AND LOSSES OF THE GROUP AS A WHOLE

A. When An Affiliated Group Files A Consolidated Return, The Group Is The Taxpayer

1. *The Consolidated Return Regulations And The Code As Applied In the Consolidated Return Context Treat The Group As The Taxpayer*

Under the Code and the consolidated return regulations, an affiliated group that files a consolidated return computes and pays its tax as a single entity. For example, the tax liability of the group is computed on a consolidated basis rather than apportioned among individual members. *See* Treas. Reg. § 1.1502-2(a) (prescribing formula for "[t]he tax liability of a group"). Accordingly, the group's tax liability is computed by applying the corporate tax rate specified in 26 U.S.C. § 11 to the income of the group. *See* Treas. Reg. § 1.1502-2(a).

The group's income is itself computed on a consolidated basis, *see* Treas. Reg. § 1.1502-11 (prescribing formula for "consolidated taxable income"), as is the group's net operating loss. *See* Treas. Reg. § 1.1502-21(f) (prescribing formula for "consolidated net operating loss"). In addition, subject to an exception not applicable here,[5] the net operating loss of a group as computed under Treas. Reg. § 1.1502-21(f) can only be carried forward or back by the group as a whole, not by its individual members. *See* Treas. Reg. § 1.1502-11(a)(2).

That the group is the taxpayer in the consolidated return context is further demonstrated by the application in that context of other statutory provisions which, like § 172(b)(1)(I), employ the term "taxpayer." For example, the Code provides that "any taxpayer entitled to a 10-year carryback" for product liability losses—which is the very carryback at issue here—may elect to waive the extended carryback for such losses. *See* 26 U.S.C. § 172(j)(3).[6] In the consolidated return context, the uniform practice of the Service has been to treat the *group* rather than the individual members thereof as the "taxpayer" entitled to make this election. *See* I.R.S. Private Letter Ruling ("P.L.R.") 94-44-020 (Aug. 2, 1994); P.L.R. 94-41-020 (July 8, 1994).[7]

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[5] The exception arises in certain cases where a member joined the group during the carryback period for the group's consolidated net operating loss. In such cases, if certain conditions are met, a portion of the group's consolidated net operating loss must be separately apportioned to the member that recently joined. *See* Treas. Reg. § 1.1502-79(a). It is undisputed, however, that no such apportionment is required here.

[6] This provision now appears at 26 U.S.C. § 172(f)(6).

[7] Private letter rulings, technical advice memoranda, general counsel memoranda and field service advice issued by the Service are not used or cited as precedent pursuant to §6110(k)(3), but they are widely relied upon in practice because they "do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws." *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 686

Similarly, § 172(b)(3) of the Code provides that "any taxpayer" entitled to a 3-year carryback for a net operating loss may elect to waive the carryback. Again, in the consolidated return context, the uniform practice of the Service has been to treat the group as the "taxpayer" entitled to make this election. *See* I.R.S. Technical Advice Memorandum ("T.A.M.") 88-16-002 (Dec. 31, 1987); T.A.M. 84-48-004 (July 31, 1984); T.A.M. 81-45-027 (July 31, 1981); I.R.S. General Counsel Memorandum ("G.C.M.") 39,305 (July 27, 1984).

In addition, § 6501(c)(4) of the Code provides that a "taxpayer" may waive the statute of limitations period for collection of any tax imposed under the Code. Here too, when a group files a consolidated return, the Service treats the group as the taxpayer entitled to make this election. *See* Treas. Reg. § 1.1502-77(a) (subject to limited exceptions not relevant here, the "common parent" acts as agent for all members of the group as to "all matters relating to the tax liability for the consolidated return year").

Thus, under the Code and applicable regulations, the affiliated group and not its individual members is treated as the "taxpayer" in years when the group files a consolidated return. Under § 172(j), therefore, the "taxpayer" whose product liability expenses and net operating loss are to be compared is the group, not its individual members.

As a result, the computation under § 172(j) is a straightforward one: The group's product liability loss is the lesser of its product liability expenses and its consolidated net operating loss as calculated under Treas. Reg. § 1.1502-21(f). *See* § 172(j)(1).

(1962). *See, also, Rowan Cos.* v. *United States*, 452 U.S. 247, 261 n.17 (1981).

2. *The Purposes Of The Consolidated Return Provisions Support Computing Product Liability Losses On A Consolidated Basis*

In addition to being consistent with the relevant statutory and regulatory text, the approach advocated by Petitioner and adopted by the Sixth Circuit is the only one consistent with the purpose of § 1501 and the consolidated return regulations. That purpose is simply to recognize that an affiliated group is in reality a single business unit. Thus, the Senate Finance Committee recommended passage of the earliest predecessor to § 1501 expressly "because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and the Government." S.Rept. No. 617, 65th Cong., 3d Sess. 9 (1918); *see also* H.R. Rep. No. 100-391, pt. 2, at 1089 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-704 ("The original justification for the consolidated return provisions of the Code was that individual members of a controlled group of corporations should, as a matter of equity and convenience for both the government and the taxpayer, be taxed as a single business unit"); *Amorient, Inc.* v. *Commissioner,* 103 T.C. 161, 168 (1994) ("[t]he consolidated return provisions were enacted for the purpose of taxing an affiliated group of corporations as a single, economic 'business unit'").

Taxing a group as a single business unit allows the group to blend the income and losses of its individual members. Thus, as the Service itself has recognized, "corporations that file a consolidated return should be able to use each other's losses as if they were divisions of a single corporation rather than separate corporations." *Consolidated Returns—Limitations on the Use of Certain Losses, Deductions and Credits*, 56 Fed. Reg. 4,228 (January 29, 1991).

Allowing an affiliated group to blend the income and losses of its members serves important economic purposes. By rendering more tax-neutral the group's decisions to form

new members or to transfer assets among existing members, the consolidated return provisions allow groups to make such decisions on the basis of economic efficiency rather than tax avoidance. The result is increased productivity, greater profits, and, ultimately, larger tax revenues.

These purposes are directly advanced by applying § 172(j) in the manner urged by Petitioner and adopted by the Sixth Circuit. Under that approach, affiliated groups are free to make economic decisions based on economic criteria, without fear of losing an extended carryback for product liability losses.[8] Moreover, as discussed above, the text of the relevant statutory and regulatory provisions afford no occasion for departure from these policies in applying § 172(j) to a group that files a consolidated return. Thus, as a matter of text and policy, the determination of a group's product liability losses under § 172(j) should be made on the basis of the aggregate product liability expenses and consolidated net operating loss of the group, not of each of its individual members.

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[8] Consider, for example, a corporation with a net operating loss of $1000 and a division that generates positive net income but that incurs product liability expenses of $500. As a single entity, the corporation would be entitled to a $500 carryback for product liability losses (which equals the lesser of the corporation's net operating loss and product liability expenses). Under Petitioner's approach, if the corporation chose to incorporate the division as a separate corporation and to file a consolidated return, it would retain the full $500 carryback for product liability losses, because the § 172(j) calculation would be made by comparing the net operating loss and product liability expenses of the group as a whole. Petitioner's approach therefore does not distort the decision whether to incorporate the division. Under a member-level approach, however, the group would lose the entire carryback because the member incurring the product liability expenses is separately profitable. Accordingly, the member-level approach introduces significant tax distortions into operational decisions.

3. *The United States' Criticisms Of The Consolidated Approach Are Misguided*

The United States has made four principal arguments in litigating this case and *Intermet*, none of which have merit.

a. First, the United States asserts that the term "taxpayer" as used in § 172(b)(1)(I) should be understood to refer to individual members rather than to the group as a whole. In support of this assertion, the United States cites 26 U.S.C. §§ 7701(a)(1) and (14), which state a general rule that the term "taxpayer" "shall be construed to mean and *include* an individual, a trust, estate, partnership, association, company, or corporation." (Emphasis added.) But the United States neglects to cite § 7701(b), which provides that "[t]he terms 'includes' and 'including' when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined." As discussed above, the consolidated return regulations and various statutory provisions as applied in the consolidated return context treat an affiliated group that files a consolidated return as being within the meaning of the term "taxpayer." Moreover, unlike §§ 7701(a)(1) and (14), these provisions are specific to the context of consolidated returns. Consequently, the United States errs in suggesting that §§ 7701(a)(1) and (14) exclude affiliated groups from the meaning of the term "taxpayer" in this context.

In addition, the United States has occasionally, but mistakenly, relied on two cases from this Court in arguing that the group cannot be the taxpayer under § 172(j). The first is *Woolford Realty Co.* v. *Rose*, 286 U.S. 319 (1932). There, the petitioner, Woolford Realty, affiliated with the Piedmont Savings Company in 1927. Piedmont had suffered net losses in 1925 and 1926. Woolford filed a consolidated return in 1927, and sought to carry *forward* Piedmont's pre-affiliation losses to offset Woolford's income in 1927. This Court held it could not, reasoning that Woolford and

Piedmont were separate taxpayers as that term was used in the carry*forward* statute at issue there.

Woolford Realty is distinguishable on factual and legal grounds. First, Woolford and Piedmont were not affiliated during the years in which the losses at issue were incurred. Thus, the two companies were separate taxpayers during those years. The carryforward statute used the term "taxpayer" in reference to the year in which a loss was incurred. *See* 286 U.S. at 326 (statute referred to "'any taxable year . . . in which any taxpayer has sustained a net loss'"). Thus, the Court held, Woolford and Piedmont were separate taxpayers for the purposes of the statute.

Here, in contrast, the members incurring product liability expenses *were* members of the affiliated group during the years in which the expenses were incurred. Section 172, like the carryforward statute in *Woolford Realty*, uses the term "taxpayer" in reference to the year in which a product liability loss is incurred. *See* 26 U.S.C. § 172(b)(1)(I) (referring to "a taxpayer which has a product liability loss . . . for a taxable year"). Thus, the members incurring product liability expenses here were part of the same "taxpayer" for purposes of § 172.

Second, the consolidated return statute in *Woolford Realty* differed fundamentally from the one at issue here. There, the statute imposed a tax "upon the respective affiliated corporations 'on the basis of the income properly assignable to each.' " 286 U.S. at 328 (quoting 26 U.S.C. § 240(b) of the Internal Revenue Code of 1926). By imposing a distinct tax liability on each member of a group, the statute clearly treated each member as a separate taxpayer. Here, in contrast, § 1501 and the consolidated return regulations impose a single, undivided tax liability on the group as a whole. *See* Treas. Reg. § 1.1502-2(a) (prescribing formula for "[t]he tax liability of a *group*") (emphasis added).

Consequently, § 1501 and the regulations treat the group as the taxpayer.

The United States likewise errs in relying upon *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). There, Uly Thompson, who was the majority shareholder of Moline Properties, Inc. ("Moline"), argued that the income from a sale by Moline to a third party should have been attributed directly to Thompson for tax purposes. This Court disagreed, holding that the corporation was separate from its shareholder for tax purposes as for others. The case did not involve the filing of a consolidated return, however, and thus did not address the issue whether an affiliated group is a taxpayer when it files such a return.

b. The United States' second criticism of the consolidated approach concerns the computation of "separate taxable income" under Treas. Reg. § 1.1502-12. Under this regulation, a member's separate taxable income "is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations," subject to substantial modifications. *Id; see also infra,* at 18-19. Product liability expenses are considered in determining a member's separate taxable income. *See* Treas. Reg. § 1.1502-12. Accordingly, the United States argues that such expenses are "absorbed" in cases where the member has positive separate taxable income; and this, according to the United States, precludes a product liability loss for such expenses under § 172(j)(1).

This is an argument more metaphysical than legal. Under the text of the regulations, separate taxable income is merely an intermediate calculation made in computing the consolidated taxable income and consolidated net operating loss of the group. *See* Treas. Reg. § 1.1502-11(a)(1) (setting forth multi-step formula for computing consolidated taxable income); Treas. Reg. § 1.1502-21(f) (setting forth similar formula for computation of consolidated net operating loss).

No tax is imposed on "positive" separate taxable income, and "negative" separate taxable income cannot be carried back to offset income in prior tax years. To the contrary, tax is imposed only on consolidated taxable income, and only consolidated net operating losses can be carried back to prior tax years. *See* Treas. Reg. §§ 1.1502-2(a), 1.1502-21.

Thus, as the Sixth Circuit correctly observed, separate taxable income "has no independent significance"; rather, it "is simply a step along the way to calculating a group's taxable income or [consolidated net operating loss]." *Intermet,* 209 F.3d at 906. By arguing that product liability expenses are somehow "absorbed" by positive separate taxable income, the United States assigns separate taxable income a significance it lacks under the text of the regulations.

c. Third, the United States asserts that product liability losses are not among the deductions that Treas. Reg. §§ 1.1502-22 to -27 expressly direct to be computed on a consolidated basis. From this the United States infers that product liability losses should be computed on an individual-member basis. The sections of the Code that authorize these deductions, however, differ in a critical respect from § 172(j). Those sections explicitly or implicitly make the referenced deductions available to "a corporation," which term arguably does not encompass an affiliated group.[9] Thus, absent an

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[9] *See* Treas. Reg. § 1.1502-22 (concerning 26 U.S.C. § 1211(a) limitation on the capital losses of "a corporation" and 26 U.S.C. § 1212(a) capital loss carryback of "a corporation"); Treas. Reg. § 1.1502-23 (concerning 26 U.S.C. § 1231 gains and losses); Treas. Reg. § 1.1502-24 (concerning charitable contribution deduction of "a corporation" under 26 U.S.C. § 170(b)(2)); Treas. Reg. § 1.1502-25 (concerning 26 U.S.C. § 922 deduction for a "Western Hemisphere Trade corporation"); Treas. Reg. § 1.1502-26 (concerning dividends received deduction allowed to "a corporation" under 26 U.S.C. §§ 243(a)(1), 244(a) and 245); and Treas. Reg. § 1.1502-27 (concerning 26 U.S.C. § 247 limitation on deductions of dividends paid by a public utility, which is "a corporation").

express regulatory directive to compute these deductions on a consolidated basis, they arguably would have to be computed on an individual-member basis. *Cf. First Chicago NBD Corporation* v. *Commissioner*, 135 F.2d 457 (CA7 1998) (refusing to permit aggregation of stock ownership by an affiliated group for purposes of § 902 foreign tax credit because § 902 refers to "a corporation").

Section 172(j) in contrast, uses the term "taxpayer," which does encompass an affiliated group that files an consolidated return. Thus, unlike the deductions discussed above, there is no textual inference that product liability losses must be computed on an individual-member basis. Accordingly, they can be computed on a consolidated basis.[10]

d. Finally, the Service has argued in prior briefs, and the Fourth Circuit reasoned in this case, that computing product liability losses at the group rather than the member level would create a "windfall" for the group. *United Dominion*, 208 F.3d at 458. The assumption here—and it is one that

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[10] There is a simple factual explanation for the composition of the list of deductions cited by the United States (which is set forth in Treas. Reg. §§ 1.1502-22 to -27). The consolidated return regulations, including the list cited by the United States, were first promulgated in 1966. Product liability losses were not on the original list because they did not exist at that time. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 371 (creating carryback for product liability losses). The Service has been exceedingly slow to update the list, which is shown by the fact that certain items on it reflect provisions of the Code that have since been modified or repealed. *See, e.g.*, Treas. Reg. § 1.1502-24 (1998) (limiting charitable deductions to five percent of adjusted consolidated taxable income, although Congress increased this percentage to 10 in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 263); Treas. Reg. § 1.1502-26 (1998) (providing for 85% "dividends received" deduction, although Congress reduced this percentage to 70 in the Revenue Act of 1987, Pub. L. No. 100-203, § 10221(a)(1)). Thus, the fact that product liability losses are not on the list cited by the United States is of little or no probative significance.

underlies the entirety of the United States' position in this case—is that, if a member would not have had a product liability loss on a separate return, then the group cannot have such a loss on a consolidated return. But the tax that a group's members would have incurred had they filed separate returns cannot be the measure of the tax that a group should incur in filing a consolidated return. If it were, there would be no reason to file a consolidated return. Indeed, the very purpose of the consolidated return provisions is to permit an affiliated group to blend the losses and income of its individual members, a blending that will almost always affect the amount of tax paid by the group. Thus, by incorrectly assuming that § 1501 and the consolidated return regulations must yield a result equivalent to that reached pursuant to the filing of separate returns, the Service and the Fourth Circuit would do much to render those provisions a nullity.

B. The Member-Level Approach Is Unsound And Unworkable

1. *The Member-Level Approach Is Contrary To The Text Of § 172(j)*

The position of the United States and the Fourth Circuit is contrary to the plain text of § 172(j). As noted above, § 172(j) provides that a taxpayer's product liability loss is equal to the lesser of the taxpayer's product liability expenses and net operating loss. Under the consolidated approach advocated by Petitioner and adopted by the Sixth Circuit, this computation involves a straightforward comparison of the group's aggregate product liability expenses and consolidated net operating loss as calculated under Treas. Reg. § 1.1502-21(f). This approach thus involves a comparison of the very items specified in § 172(j).

The same is not true of the member-level approach. Under that approach, "each member must initially compute its product liability loss (if any) on an individual basis." Brief

12. These individual product liability losses are then aggregated and compared to the consolidated net operating loss of the group, with the group's product liability loss equaling the lesser of those two amounts. *Id.;* T.A.M. 9715002 (Dec. 12, 1996). The group's product liability loss, therefore, is the lesser of the aggregated individual product liability *losses* and the group's consolidated net operating loss.

This is not the comparison mandated by § 172(j)(1). That section states that a taxpayer's product liability loss is the lesser of the taxpayer's net operating loss and the taxpayer's product liability *expenses*, not the taxpayer's product liability *losses*. Product liability expenses, which are defined by § 172(j)(1)(B), are very different from product liability losses, which are separately defined in § 172(j)(1). The Fourth Circuit itself recognized this difference, though it failed to modify its analysis accordingly. *See United Dominion*, 208 F.3d at 458 ("the tax regulations plainly provide the ten-year carryback only for 'product liability *loss*' (and not for product liability *expense*)") (emphasis added). The member-level approach thus constitutes a clear departure from the text of § 172(j), and for that reason should be rejected.

2. *The Member-Level Approach Is Incoherent*

As noted above, § 172(j) requires a comparison of a taxpayer's product liability expenses and net operating loss. When an affiliated group files a consolidated return, the net operating loss for the group is calculated on a consolidated basis. *See* Treas. Reg. § 1.1502-21(f). Thus, the member-level approach raises the question of what is to serve as the "net operating loss" for purposes of calculating the individual product liability loss of a member of a group that files a consolidated return.

The United States and the Fourth Circuit offer different answers to this question.[11] The United States argued in the Fourth and Sixth Circuits that a member's "separate taxable income" under Treas. Reg. § 1.1502-12 should serve as the equivalent of a net operating loss for computing the member's product liability loss. *See United Dominion*, 208 F.3d at 459; *Intermet*, 209 F.3d at 906. Thus, according to the United States, a member's product liability loss is the lesser of its "negative" separate taxable income and its product liability expenses.[12]

The Fourth Circuit expressly rejected the United States' argument concerning the use of a member's separate taxable income in computing the member's product liability loss. *United Dominion*, 208 F.3d at 459. Instead, the Fourth Circuit concluded, the member's "separate net operating loss," computed under Treas. Reg. § 1.1502-79(a)(3), should be used instead. Thus, according to the Fourth Circuit, a member's product liability loss is the lesser of its "separate

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[11] The United States seeks to avoid discussion of this question by dismissing it as "irrelevant to the legal issue presented by this case." Brief For The United States On Petition For A Writ Of Certiorari 13, n. 12. Whether the details of the member-level approach to calculating a group's product liability loss render that approach unworkable, however, certainly is relevant to whether the approach should be adopted. This point is demonstrated by the fact that the Fourth Circuit devoted the better part of its analysis to the very question the United States now seeks to avoid. *See United Dominion*, 208 F.3d at 459-461.

[12] The Service has adopted "shifting and incongruous reasoning" as to the measure used for computing a member's product liability loss, with the formula quoted in the text being only the latest iteration thereof. *See Intermet*, 209 F.3d at 908. Consequently, the Service's position in this case is entitled to little if any deference. *See, e.g., I.N.S.* v. *Cardoza-Fonseca*, 480 U.S. 421, 446 n. 30 (1987) ("An agency interpretation of a relevant provision which conflicts with the agency's earlier interpretation is 'entitled to considerably less deference' than a consistently held view") (quoting *Watt* v. *Alaska*, 451 U.S. 259, 273 (1981)).

net operating loss" and its product liability expenses. *Id.* at 461.

a. Neither of the measures proposed by the United States or the Fourth Circuit withstand scrutiny. The United States errs in arguing that a member's separate taxable income is the equivalent of its net operating loss for purposes of computing its product liability loss. On this point there is no circuit split. *See United Dominion*, 208 F.3d at 460 (expressly "reject[ing] the IRS's proposed reference to the member's 'separate taxable income' in the determination of whether the member's product liability expenses are 'product liability loss'"); *Intermet*, 209 F.3d at 907 ("reject[ing the Service's] analysis" regarding separate taxable income).

There are good reasons for this consensus among the circuits. First, the United States' position on this point is clearly at odds with the text of § 172(j) and the consolidated regulations. As discussed *supra* at 12-13, a member's separate taxable income is merely one component in the formula for calculating a group's consolidated taxable income and consolidated net operating loss under Treas. Regs. §§ 1.1502-11 and - 21(f). Accordingly, a member's separate taxable income is something quite different from a net operating loss as defined by § 172(c) or Treas. Reg. § 1.1502-21(f). Thus, just as the United States advocates a comparison of items other than those specified in § 172(j) in computing a *group's* product liability loss, *see supra* at 15-16, so too the United States advocates a comparison of items other than those specified in that section in computing a *member's* product liability loss. Its position, in short, is altogether unmoored from the statutory text.

The United States' position makes little sense even if one accepts the mistaken premise that underlies it, namely, that if a member would not have had a product liability loss on a separate return, then the group cannot have such a loss on a consolidated return. Under Treas. Reg. § 1.1502-12, a

member's separate taxable income does *not* include certain income and deductions that *would* be included on a member's separate return. These include, for example, charitable deductions and capital gains and losses. *See* Treas. Reg. § 1.1502-12(l), (j). This was a point that the Fourth Circuit emphasized at some length. *See United Dominion,* 208 F.3d at 459 (stating that "we agree" with the taxpayer's assertion that "'separate taxable income' by definition excludes income and deductions that would be incorporated in calculating the group member's taxable income or net operating loss, if the group member had filed a separate tax return"); *see also id.* at 456.

Thus, as the United States concedes in its brief, "[i]t is possible for a corporation to compute positive separate taxable income [thus precluding a product liability loss under the United States' theory] even though the corporation would have reported a net operating loss had it filed a separate return." Brief For The United States On Petition For A Writ Of Certiorari 11, n. 9. "Conversely, it is possible for a corporation to compute negative separate taxable income even though it would have reported positive income had it filed a separate return." *Id.*

The use of separate taxable income in determining a member's product liability loss, therefore, yields results that are "flatly contrary to the separate tax return analogy from § 172(j)." *United Dominion,* 208 F.3d at 459. Thus, even if one makes the mistake of accepting that analogy, the measure proposed by the United States can only be regarded as arbitrary.

b. The measure proposed by the Fourth Circuit fares little better. As noted above, the Fourth Circuit held that a member's "separate net operating loss" under Treas. Reg. § 1.1502-79(a) should be used in computing the member's individual product liability loss under § 172(j). By its terms, however, Treas. Reg. § 1.1502-79(a) governs only the

question whether a portion of a group's consolidated net operating loss (as computed under Treas. Reg. § 1.1502-21(f)) must be "apportioned" to an individual member that filed a separate return during the carryback period for the loss.

Here, it is undisputed that Treas. Reg. § 1.1502-79(a) does not require any portion of Petitioner's consolidated net operating loss to be apportioned to a "separate return year," Treas. Reg. § 1.1502-1(e), of any of its members. The Fourth Circuit simply invented a measure for computing a member's product liability loss that has no support in the text of the regulations. As the Sixth Circuit observed in reaching its contrary conclusion: "The [Fourth Circuit] offered no analysis to support its conclusion that [Treas. Reg. § 1.1502-79(a)(3)] dictates a method for calculating a member's 'separate net operating loss' outside of the separate return context." *Intermet*, 209 F.3d at 908.

The Fourth Circuit is also incorrect in suggesting that a member's separate net operating loss under Treas. Reg. § 1.1502-79(a) is identical to the net operating loss that a member would compute on a separate return. Under Treas. Reg. § 1.1502-79(a)(3), the formula for computing a member's separate net operating loss makes no reference to the net operating loss that a member might compute on a separate return. Those computations, therefore, are likely to yield differing amounts.

The misguided nature of the Fourth Circuit's analysis—and the overwhelming complexity of the member-level approach to computing product liability losses—is further shown by the fact that the Court confused the very measure it invented. As noted above, the Fourth Circuit held that a member's product liability loss is the lesser of its product liability expenses and "separate net operating loss" as computed under Treas. Reg. § 1.1502-79(a). That regulation requires two separate computations in cases where it applies: First, a computation

of a member's separate net operating loss;[13] and second, a computation of the amount, if any, of the group's consolidated net operating loss that must be apportioned to a member that files such a return.[14]

Here, it is unclear which computation the Fourth Circuit meant to use. On the one hand, the Court asserted that a member's product liability loss should be calculated "[b]y comparing [its] product liability expenses to its 'separate net operating loss[.]'" 208 F.3d at 460. This comparison would utilize the separate net operating loss computation. But, on the other hand, the Court stated that "application of th[e] *apportionment* formula to the issue in this case results in logical consistency of the general consolidated return framework, and the specific resolution of the issue in this case." *Id.* (emphasis added); *see also id.* at 460 n. 16 (quoting the apportionment computation). This statement suggests that a member's product liability expenses should be compared to its *apportionment* computation.

But the critical point for this case is not which of the computations should have been used below; neither should have been used, since the member-level approach should be rejected *simpliciter*. The critical point, rather, is that the Fourth Circuit invented a measure which reflects the confusion inherent in the member-level approach. This is reason enough to reject the member level approach.

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[13] The separate net operating loss of a member that files a separate return during the carryback period is the member's separate taxable income plus a portion of certain deductions, losses, and income of the group. Treas. Reg. § 1.1502-79(a)(3).

[14] This amount is "equal to the consolidated net operating loss multiplied by a fraction, the numerator of which is the separate net operating loss of [the member that filed the separate return during the carryback period], and the denominator of which is the sum of the separate net operating losses of all members of the group in such year having such losses." Treas. Reg. § 1.1502-79(a)(3).

3. *The Member-Level Approach Is Unworkable*

a. The member-level approach would enmesh taxpayers, the Service, and the courts in difficult, subsidiary questions that do not arise under Petitioner's approach. One such question is discussed above, concerning the measure used in computing a member's product liability loss. That the United States and the Fourth Circuit pointedly disagree on the answer to this question—and that each of their answers is wrong—is a clear indication of the difficulties that attend their approach.

Another abstruse question that arises under the member-level approach—but not Petitioner's—concerns the computation of the group's product liability loss after the members' individual product liability losses are computed. As noted previously, § 172(j)(1) states that a taxpayer's product liability loss is the lesser of its net operating loss and its product liability expenses. This is known as the "stacking rule," because its effect is to offset the taxpayer's income with product liability expenses only after all other deductions are absorbed by income. For example, if a taxpayer has $300 of income, $100 of product liability expenses, and $300 of other (*i.e.*, non-product liability) deductions, the stacking rule ensures that the other deductions are used to offset income, and that the entire $100 of product liability expenses remains available for the extended, 10-year carryback.

The application of the stacking rule under the member-level approach is arguably uncertain. As shown above, the stacking rule applies through the device of comparing the taxpayer's net operating loss and product liability expenses. As noted *supra* at 15-16, however, the member-level approach departs from the text of § 172(j)(1) by requiring a comparison of the group's consolidated net operating loss and the aggregate of the members' product liability *losses*, rather than product liability *expenses*, as specified in § 172(j)(1).

This takes the computation of the group's product liability loss out of the literal scope of the stacking rule.

The question thus arises whether this computation should nonetheless be guided by the stacking rule. If so, the group's product liability loss would be the lesser of its net operating loss and the aggregate of the members' product liability losses. If not, the members' product liability losses might offset the income of the group's members on a proportionate basis.

To appreciate the difference between these approaches, consider a group with two members having aggregate product liability losses of $500, another member having $2000 of income, and a fourth member having $2000 of other deductions during a consolidated return year. Under the stacking rule—according to which product liability losses are "used last" to offset member income—the other deductions alone would fully offset the third member's income, leaving a product liability loss for the group of the full $500. But under the proportionate approach, the product liability losses would offset income commensurate with their share of the total losses of the group's members. In this example, product liability losses comprise one-fifth of the group's total losses. Thus, for every four dollars of other deductions used to offset member income, one dollar of product liability losses would be so used. Accordingly, under the proportionate approach, the group would be left with a product liability loss of only $100 after its income is offset.

Amici believe it is clear that the stacking rule should always apply in computing product liability losses. Section § 172(j)(1) reflects a clear policy that product liability losses be preserved to the greatest possible extent in offsetting taxpayer income. To disregard that policy because of the member-level approach's departure from the statutory text is

only to compound the error of departing from the text in the first place.[15]

But the critical point for this case is that Petitioner's approach avoids all these questions. By using the text and policy of the Code and regulations as its guide, Petitioner's approach avoids the dense undergrowth of subsidiary issues raised by the member-level approach.

b. The member-level approach would also entail significantly increased administrative burdens. In addition to creating legal disputes of the sort described above, the member-level approach would multiply the factual disputes between taxpayers and the Service under § 172(j). It would do so because the location of assets and the origin of losses within a group would matter. If the § 172(j) comparison of product liability expenses and net operating loss is to be made at the individual-member level, the existence of a product liability loss – and thus the availability of the extended 10-year carryback—may well depend on whether a particular item of income, or a particular liability loss, is attributed to one or another member. Because affiliated groups generally operate as a single business unit, these are questions as to which taxpayers and the Service can and will disagree.

In contrast, under Petitioner's approach, these questions do not arise because the location of assets or origin of losses within the group generally will not affect whether the group has a product liability loss. For this reason as well, then, the

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[15] In addition, Treas. Reg. § 1.1502-21(b)(1), which governs the carryback of a group's consolidated net operating loss (of which its product liability loss is a part) states that the carryback of a consolidated net operating loss is determined "under the principles of § 172(b)." Section 172(b)(1)(I), which authorizes the 10-year carryback for product liability losses, in turn expressly refers to § 172(j), which contains the stacking rule.

member-level approach should be rejected, and Petitioner's approach adopted.

CONCLUSION

The judgment of the Fourth Circuit should be reversed.

Respectfully submitted,

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